

# State Office of Administrative Hearings



Cathleen Parsley  
Chief Administrative Law Judge

December 3, 2012

Les Trobman, General Counsel  
Texas Commission on Environmental Quality  
P.O. Box 13087  
Austin Texas 78711-3087

Re: SOAH Docket No. 582-11-1468; TCEQ Docket No. 2010-1841-UCR; In Re: Application of SJWTX, Inc. d/b/a Canyon Lake Water Service Company to Change Water Rates; CCN No. 10692; In Comal and Blanco Counties

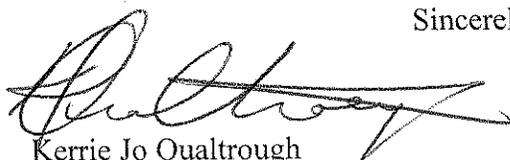
Dear Mr. Trobman:

The above-referenced matter will be considered by the Texas Commission on Environmental Quality on a date and time to be determined by the Chief Clerk's Office in Room 201S of Building E, 12118 N. Interstate 35, Austin, Texas.

Enclosed are copies of the Proposal for Decision and Order that have been recommended to the Commission for approval. Any party may file exceptions or briefs by filing the documents with the Chief Clerk of the Texas Commission on Environmental Quality no later than December 27, 2012. Any replies to exceptions or briefs must be filed in the same manner no later than January 7, 2013.

This matter has been designated **TCEQ Docket No. 2010-1841-UCR; SOAH Docket No. 582-11-1468**. All documents to be filed must clearly reference these assigned docket numbers. All exceptions, briefs and replies along with certification of service to the above parties shall be filed with the Chief Clerk of the TCEQ electronically at <http://www10.tceq.state.tx.us/epic/efilings/> or by filing an original and seven copies with the Chief Clerk of the TCEQ. Failure to provide copies may be grounds for withholding consideration of the pleadings.

Sincerely,

  
Kerrie Jo Qualtrough  
Administrative Law Judge

  
Penny A. Wilkov  
Administrative Law Judge

KJQ/ap  
Enclosures  
cc: Mailing List

**STATE OFFICE OF ADMINISTRATIVE HEARINGS**

**AUSTIN OFFICE**  
300 West 15th Street Suite 502  
Austin, Texas 78701  
Phone: (512) 475-4993  
Fax: (512) 322-2061

**SERVICE LIST**

**AGENCY:** Environmental Quality, Texas Commission on (TCEQ)  
**STYLE/CASE:** SJWTX INC / CANYON LAKE WATER SERVICE CO  
**SOAH DOCKET NUMBER:** 582-11-1468  
**REFERRING AGENCY CASE:** 2010-1841-UCR

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**STATE OFFICE OF ADMINISTRATIVE  
HEARINGS**

**ADMINISTRATIVE LAW JUDGE**  
**ALJ KERRIE QUALTROUGH**

---

**REPRESENTATIVE / ADDRESS**

**PARTIES**

SCOTT HUMPHREY  
ATTORNEY  
TEXAS COMMISSION ON ENVIRONMENTAL QUALITY  
OFFICE OF PUBLIC INTEREST COUNSEL  
P. O. BOX 13087, MC-103  
AUSTIN, TX 78711-3087  
(512) 239-0574 (PH)  
scott.humphrey@tceq.texas.gov

OFFICE OF PUBLIC INTEREST COUNSEL

---

MARK ZEPPA  
ATTORNEY  
LAW OFFICE OF MARK H. ZEPPA, P.C.  
4833 SPICEWOOD SPRINGS RD., SUITE 202  
AUSTIN, TX 78759-8436  
(512) 346-4011 (PH)  
(512) 346-6847 (FAX)  
markzeppa@austin.rr.com

CHARLES LOY

THOMAS HODGE

PALLE JENSEN

SJWTX, INC. D/B/A CANYON LAKE WATER SERVICE  
COMPANY

---

PAUL TERRILL  
ATTORNEY  
THE TERRILL FIRM, P.C.  
810 WEST 10TH STREET  
AUSTIN, TX 78701  
(512) 474-9100 (PH)  
(512) 474-9888 (FAX)  
pterrill@terrill-law.com

SJWTX, INC. D/B/A CANYON LAKE WATER SERVICE  
COMPANY

---

BRIAN MCLEOD  
STAFF ATTORNEY  
TEXAS COMMISSION ON ENVIRONMENTAL QUALITY  
MC-173 P.O. BOX 13087  
AUSTIN, TX 78711-3087  
(512) 239-0750 (PH)  
(512) 239-0606 (FAX)  
bmacleod@tceq.state.tx.us

TCEQ EXECUTIVE DIRECTOR

---

SHARI HEINO  
MATHEWS & FREELAND, L.L.P.  
327 CONGRESS AVE., SUITE 300  
AUSTIN, TX 78701  
(512) 404-7800 (PH)  
(512) 703-2785 (FAX)  
shari@mandf.com

WILLIAM STEPHENS

PAUL E GRAF

DEENA CLAUSEN

NELISA HEDDIN

GEOFFREY MILLER

COALITION FOR EQUITABLE WATER RATES

---

DOUG MILLER  
STATE REPRESENTATIVE DISTRICT 73  
387 W. MILL ST.  
NEW BRAUNFELS, TX 78130  
(830) 624-8338 (PH)

(COURTESY COPY)

SOAH DOCKET NO. 582-11-1468  
TCEQ DOCKET NO. 2010-1841-UCR

APPLICATION OF SJWTX, INC. DBA § BEFORE THE STATE OFFICE  
CANYON LAKE WATER SERVICE §  
COMPANY TO CHANGE WATER § OF  
RATES; CCN NO. 10692; IN COMAL §  
AND BLANCO COUNTIES § ADMINISTRATIVE HEARINGS

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**SOAH DOCKET NO. 582-11-1468  
TCEQ DOCKET NO. 2010-1841-UCR**

<b>APPLICATION OF SJWTX, INC. DBA</b>	<b>§</b>	<b>BEFORE THE STATE OFFICE</b>
<b>CANYON LAKE WATER SERVICE</b>	<b>§</b>	
<b>COMPANY TO CHANGE WATER</b>	<b>§</b>	<b>OF</b>
<b>RATES; CCN NO. 10692; IN COMAL</b>	<b>§</b>	
<b>AND BLANCO COUNTIES</b>	<b>§</b>	<b>ADMINISTRATIVE HEARINGS</b>

**PROPOSAL FOR DECISION**

**I. INTRODUCTION**

On August 27, 2010, SJWTX, Inc., doing business as Canyon Lake Water Service Company (CLWSC), filed a request with the Texas Commission on Environmental Quality (Commission or TCEQ) to change its water rates in Comal and Blanco Counties. CLWSC requested a total annual revenue requirement of \$11,566,730.<sup>1</sup> CLWSC also requested recovery of rate case expenses through a surcharge added to monthly bills for two years. In response to protests filed by at least ten percent of CLWSC's customers, the Commission referred the matter to the State Office of Administrative Hearings (SOAH).

This Proposal for Decision (PFD) recommends that the Commission partially grant CLWSC's request to increase rates, subject to several adjustments. It also recommends that the Commission authorize CLWSC to recover rate case expenses of \$856,742.42 as a billing surcharge over a two-year period. The Administrative Law Judges (ALJs) request the Executive Director (ED), when he files exceptions, to provide the Commission with a calculation of the full revenue requirement and rates that incorporates the adjustments recommended in this PFD.

**II. PROCEDURAL HISTORY**

On January 6, 2011, ALJ Kerrie Jo Qualtrough convened a preliminary hearing in this matter in Austin, Texas. The following appeared and were admitted as the parties in this case:

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<sup>1</sup> CLWSC Ex. 1, p. 28. CLWSC revised its claimed revenue requirement, and it is now \$12,727,598. CLWSC Ex. 32.

Party	Representative
Applicant, SJWTX, Inc. d/b/a Canyon Lake Water Service Company	Mark Zeppa
Coalition for Equitable Water Rates (CEWR or Protestant)	Shari Heino
Thomas C. Stuebben	pro se
Thomas F. Acker	pro se
Lawrence J. Hanson	pro se
TCEQ's ED	Bryan MacLeod
TCEQ's Office of Public Interest Counsel (OPIC)	Scott A. Humphrey

Prior to issuance of Order No. 1, Mr. Stuebben, Mr. Acker, and Mr. Hanson withdrew as parties and agreed to be represented by CEWR.

At the parties' request, ALJs Qualtrough and Penny A. Wilkov agreed to bifurcate the evidentiary hearing in this proceeding. Pursuant to the parties' proposal, the ALJs convened the first evidentiary hearing on March 26 through March 30, 2012. An additional day of hearing was held on April 19, 2012. The first evidentiary hearing concerned only the merits of the Application and CLWSC's rate request. The parties then filed closing arguments on June 21, 2012, and responses on July 27, 2012.

As proposed by the parties, the ALJs convened a second evidentiary hearing on August 22 and 23, 2012, on the issue of CLWSC's rate case expenses. On September 24, 2012, the parties submitted closing arguments regarding expenses. With the filing of responses on October 8, 2012, the record closed.

The following witnesses testified at the hearing:

**For Applicant:**

Palle Jensen	Vice President of Regulatory Affairs for San Jose Water Company, an affiliate of CLWSC
Thomas A. Hodge, PE	Vice President and General Manager of CLWSC

Charles E. Loy, C.P.A.	Principal with GDS Associates, Inc. (GDS), an engineering and consulting firm
Thomas G. Gebhard, Jr., P.E., Ph.D.	Executive Engineer with GDS
Gregory E. Scheig, C.P.A./ABV/CFF/CFA	Principal with ValueScope, Inc., a financial advisory service company
Mark H. Zeppa	Senior Attorney with law firm specializing in water utility regulation
Paul M. Terrill	Partner with law firm specializing in property and environmental issues

**For CEWR:**

Nelisa Heddin	Vice President of Water Resources Management, L.L.C., a financial services company
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**For the ED:**

Debi Loockerman, C.P.A.	Financial Analyst with TCEQ
Kamal Adhikari, E.I.T.	Engineering Specialist with TCEQ

**III. BACKGROUND**

**A. CLWSC History**

Many of the complex issues in this case arise from the transfer of assets from a collection of forty-six small water companies to the member-owned, non-profit Canyon Lake Water Supply Corporation (the WSC) and then to the investor-owned utility (IOU), CLWSC. Presently, CLWSC is a state-regulated IOU providing water service to more than 9,000 connections in the Canyon Lake region of Comal County and southern Blanco County.

The water-system assets that CLWSC eventually acquired were originally owned by a number of privately-owned, state-regulated utilities near or on Canyon Lake. Most were started by developers and operated as small, “mom-and-pop” water utilities. These small systems relied on groundwater and had limited water service capacity during droughts.<sup>2</sup> The Guadalupe Blanco

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<sup>2</sup> CLWSC Ex. B, p. 5.

River Authority (GBRA) approached those groundwater-supplied utilities with a proposal to construct a regional surface water plant on Canyon Lake from which GBRA would provide them with wholesale treated drinking water. This proposal started discussions that ultimately resulted in the creation of the WSC.<sup>3</sup> The WSC was formed to build and operate its own means of treating and transporting GBRA raw water to area subdivisions.

The WSC began operations in 1994. The WSC's founders recognized that groundwater supplies alone were inadequate to support the growth of the community and that centralized water treatment plants (WTPs) would make it possible to distribute surface water from Canyon Lake to the residents surrounding the lake.<sup>4</sup> In addition, prior to the construction of the WTPs, area residents were consuming groundwater containing high levels of fluoride and other minerals. Many subdivision water systems did not have adequate water capacity during drought and frequently ran out of water.<sup>5</sup> In response, the WSC borrowed approximately \$19 million from the Texas Water Development Board (TWDB) and began constructing the necessary surface-water plants.

High population growth in western Comal County placed significant strain on the WSC's ability to provide continuous and adequate service. The WSC had difficulty financing and constructing the water-utility facilities needed to stay in compliance with TCEQ regulations while meeting growing demand for water service. Because of the need for substantial infrastructure improvements, combined with the WSC's existing debt and limited ability to raise the additional capital necessary to improve the systems, the WSC agreed to an offer from SJWTX, Inc. to acquire the WSC's assets. The WSC's membership approved the deal with CLWSC, with 76.3% voting to sell the WSC's assets to CLWSC.<sup>6</sup>

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<sup>3</sup> Canyon Lake Water Supply Corporation (the WSC) should not be confused with the IOU, Canyon Lake Water Service Company (CLWSC).

<sup>4</sup> CLWSC Ex. B, p. 5.

<sup>5</sup> CLWSC Ex. B, p. 5.

<sup>6</sup> CLWSC Ex. 3, p. 1240.

On May 31, 2006, the WSC's assets were purchased by CLWSC. The material terms of the buy-out were that CLWSC would: (1) acquire all system assets; (2) assume or discharge liabilities that, as defined, included the WSC's approximately \$19 million debt and other liabilities; (3) pay the WSC \$3.2 million in cash; (4) pay certain transaction costs and reimbursable seller income tax, as defined; and (5) agree to a two-year moratorium on water rate increases, through October 4, 2007.<sup>7</sup>

On December 22, 2005, CLWSC filed a sale, transfer, or merger application (STM) with the TCEQ. The ED reviewed the STM application, and the final order on the STM was issued on June 30, 2006.<sup>8</sup> After CLWSC acquired the WSC's water system assets, it also purchased the following water systems: two public water systems (PWSs) from the Emerald Valley Independent Aquatic Network, Ltd; four PWSs from Rancho Del Lago, Inc.,<sup>9</sup> all assets of the North Point Homeowners Water Supply Corporation;<sup>10</sup> Comal County assets of the Bexar Metropolitan Water District; and the assets of the City of Bulverde.<sup>11</sup> CLWSC currently has seven PWSs: Canyon Lake Shores; Triple Peak; Glenwood; Northpoint; North Summit; Stallion Springs; and, Rust Ranch.

## **B. Corporate Structure**

In order to understand the various transactions and issues in this case, it is helpful to understand the various corporate entities affiliated with CLWSC:<sup>12</sup>

**San Jose Water Company (SJWC)** is the largest investor-owned single district urban water system in the United States, serving over one million people in the San Jose, California,

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<sup>7</sup> CLWSC Ex. A, p. 11; Tr. p. 187-192; Tr. pp. 1318-1320, 1344; CLWSC Ex. 3, pp. 1349-1352, 1377.

<sup>8</sup> CLWSC Ex. 4.

<sup>9</sup> CLWSC Ex. B, p. 7.

<sup>10</sup> CLWSC Ex. B, p. 7.

<sup>11</sup> CLWSC Ex. B, p. 7.

<sup>12</sup> CLWSC Ex. A, pp. 8-11.

area through 225,000 service connections. SJWC was incorporated in California in 1866 and has been a subsidiary of SJW Corp. since 1985. It has about 2,400 miles of transmission lines in a 140-square mile area and 352 employees.

**SJW Corporation (SJW Corp.)** is traded on the New York Stock Exchange under the symbol SJW. SJW Corp. is operated as a holding company with four subsidiaries: SJWC; SJW Land Company, SJWTX Inc. d/b/a CLWSC; and the Texas Water Alliance Limited. SJW Corp. has no employees.

**SJW Land Company** presently owns commercial buildings and land in the San Jose, California, area, as well as properties in Florida, Texas, Arizona, Tennessee, and Connecticut. SJW Land Company is a subsidiary of SJW Corp. The company has no employees.

**SJWTX, Inc. d/b/a CLWSC** provides water service to a population of about 36,000 people through 9,200 service connections in a service area comprising about 237 square miles around Canyon Lake in western Comal County and southern Blanco County, Texas.<sup>13</sup> CLWSC was incorporated in 2005 and is a subsidiary of SJW Corp. CLWSC has 35 employees.

**Texas Water Alliance Limited**, a subsidiary of SJW Corp., is developing a water supply project in Texas. The Texas Water Alliance Limited has no employees.

### C. Overview of Proposed Rate Change

CLWSC has filed two rate/tariff change applications with TCEQ since acquiring the assets of the WSC in 2005.<sup>14</sup> Those first two rate applications, filed in 2007 and 2008, were uncontested or settled without a contested case hearing.

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<sup>13</sup> The ED's witness, Ms. Loockerman, determined that CLWSC had 9,058 connections. ED-DL-6, p. 1.

<sup>14</sup> CLWSC Ex. A, p. 17.

CLWSC filed its current application and sent notice of the rate increase to its customers on August 27, 2010. New proposed rates in the application are based on a test year of March 31, 2009, through March 31, 2010. In the application, CLWSC sought to raise its rates in two phases. The first phase (Phase 1) sought to increase the minimum monthly charge from \$30.20 to \$41.68 for the smallest meter size beginning October 27, 2010.<sup>15</sup> The second phase (Phase 2) sought to increase the minimum monthly charge from \$30.20 to \$51.60 for the smallest meter size effective March 15, 2011.<sup>16</sup> Increases were also proposed in two phases for customers with larger meters. The reason cited for the phase-in of rates was CLWSC's request that the Commission authorize it to defer depreciating its utility plant during the pendency of the rate case.<sup>17</sup>

On February 25, 2011, after referral to SOAH, CEWR and CLWSC submitted a joint motion to adopt interim rates, proposing that the Phase 1 rates would remain in effect during the pendency of this proceeding. On March 1, 2011, the ALJ issued Order No. 2 granting the joint motion. Pursuant to that agreement, interim rates were set at the Phase 1 levels, which have been charged throughout this case. All remaining portions of CLWSC's proposed tariff; including non-water service fees and assessments, were to remain unchanged and in effect as originally proposed, pending the final outcome of this proceeding.

The rates sought in this case are the Phase 2 rates, which are as follows:

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<sup>15</sup> CLWSC Ex. 1, p. 35. The first phase became effective for the Canyon Lake Shores, North Point, Rust Ranch, Stallion Springs, Summit North and Triple Peak customers on October 27, 2010. The proposed rate increase in the application became effective for the Glenwood customers on November 27, 2010.

<sup>16</sup> CLWSC Ex. 1, p. 35.

<sup>17</sup> CLWSC Ex. 1, p. 34.

Monthly Minimum Charge by Meter Size<sup>18</sup>

Previous Rates		Proposed Phase 2 Rates	
Size in inches	Charge	Size in inches	Charge
5/8 x 3/4	\$30.20	5/8	\$51.60
3/4	\$45.29	3/4	\$77.38
1	\$75.48	1	\$128.96
1 1/2	\$150.95	1 1/2	\$257.90
2	\$241.52	2	\$412.65
3	\$452.85	3	\$773.71
4	\$905.69	4	\$1,547.40
6	\$1,509.48	6	\$2,579.00
Bulk	\$241.52	Bulk	\$412.65

Charges Per 1000 Gallons (G)<sup>19</sup>

Previous Rates		Proposed Phase 2 Rates	
Size in inches	Charge	Size in inches	Charge
5/8 x 3/4	\$3.30 first 2,000G \$3.60 next 8,000G \$4.10 next 15,000G \$5.20 over 25,000G	5/8 x 3/4	\$5.64 first 2,000G \$6.15 next 8,000G \$7.01 next 15,000G \$8.88 over 25,000G
3/4	\$3.30 first 4,000G \$3.60 next 16,000G \$4.10 next 30,000G \$5.20 over 50,000G	3/4	\$5.64 first 4,000G \$6.15 next 16,000G \$7.01 next 30,000G \$8.88 over 50,000G
1	\$3.30 first 6,000G \$3.60 next 24,000G \$4.10 next 45,000G \$5.20 over 75,000G	1	\$5.64 first 6,000G \$6.15 next 24,000G \$7.01 next 45,000G \$8.88 over 75,000G
Meter size greater than 1	\$4.25 all gallons	Meter size greater than 1	\$7.26 all gallons

<sup>18</sup> CLWSC Ex. 1, p. 37.

<sup>19</sup> CLWSC Ex. 1, p. 37.

IV. RATE BASE

A. Background

The parties agree that the most important issue in this hearing is the determination of CLWSC’s rate base, also known as invested capital. The main dispute centers on how to estimate the original cost of the WSC’s assets. Not surprisingly, CLWSC’s calculation of rate base is the highest and is partially based on a trending study of the original cost of some pre-acquisition assets acquired from the WSC. CEWR’s rate-base calculation is the lowest, and the original cost is based on the price CLWSC paid for the WSC’s assets.<sup>20</sup> The ED’s calculation falls in the middle and is based on the “book values” of the assets at the time of sale and the use of a negative acquisition adjustment.<sup>21</sup> The following table shows the parties’ positions on the value of CLWSC’s rate base:

	CLWSC <sup>22</sup>	CEWR <sup>23</sup>	ED <sup>24</sup>
Plant-in-Service /Gross Plant (Original Cost)	\$68,294,995	n/a	\$64,206,901
Accumulated Depreciation	<12,282,546>	n/a	<11,248,825>
<b>Net Plant (Net Book Value)</b>	<b>\$56,012,449</b>	<b>\$45,211,841</b>	<b>\$52,958,076</b>
Working Cash Allowance	690,043	578,479	654,001
Materials and Supplies	361,235	361,235	361,235
Customers’ Deposits (Prepayments)	4,900	4,900	<116,375>
ADFIT <sup>25</sup>			<268,037>
Developer-CIAC <sup>26</sup>	<14,812,965>	<14,812,965>	<14,804,712>

<sup>20</sup> CEWR has an alternative proposal that results in a lower rate base.

<sup>21</sup> As used in this PFD, the terms “booked value,” “book value,” or “booked costs” are generic terms that represent the value of an asset shown on an entity’s financial statements. An entity may “book” an asset at its original cost, its fair market value, or some other value. The ALJs consider these terms to be synonymous.

<sup>22</sup> CLWSC Ex. 32, p. 2089. There are two versions of CLWSC’s Ex. 32 in the record. The ALJs rely on CLWSC’s Ex. 32 included in the binder of prefiled testimony.

<sup>23</sup> CEWR Ex. 1, pp. 35-36. CEWR did not recommend a value for the plant-in-service and accumulated depreciation. Also, page references are to CEWR’s Bates-stamped exhibit pages, not the page numbers of the underlying document.

<sup>24</sup> ED-DL-5, p. 3.

<sup>25</sup> “ADFIT” stands for accumulated deferred federal income tax.

<sup>26</sup> “CIAC” stands for contributions in aid of construction.

	CLWSC <sup>22</sup>	CEWR <sup>23</sup>	ED <sup>24</sup>
Customer-CIAC		<520,105>	
Advances and Cost-Free Capital (Acquisition Adjustment)	<772,550>	<772,550>	<4,791,657>
<b>Total Invested Capital (Rate Base)</b>	<b>\$41,483,112</b>	<b>\$30,050,835</b>	<b>\$33,992,530</b>

CLWSC has essentially three categories of assets: (1) assets acquired from the WSC for which it does not have reliable supporting documentation of original costs (pre-acquisition assets); (2) assets acquired from the WSC and financed through the TWDB; and (3) assets acquired or installed after the acquisition of the WSC assets (post-acquisition assets). The parties' dispute generally focuses on one category of those assets: the pre-acquisition assets without reliable supporting documentation as to original costs. The parties generally agree that there is sufficient documentation to support CLWSC's original cost of those post-acquisition assets and the pre-acquisition assets financed through the TWDB.<sup>27</sup> The following table sets out CLWSC's and the ED's valuations of original cost for the three categories of CLWSC's assets:

Assets	CLWSC Original Costs <sup>28</sup>	ED Original Costs <sup>29</sup>
Pre-Acq. Not Trended (TWDB)	\$18,701,213	\$18,701,213
Pre-Acq. Trended	10,349,699	6,812,894
Post-Acquisition	39,622,260	43,261,283 <sup>30</sup>
<b>Total Original Cost</b>	<b>\$68,673,172</b>	<b>\$68,775,390<sup>31</sup></b>

<sup>27</sup> CEWR disputes the original cost valuation for the post-acquisition assets of the Rancho del Lago water system.

<sup>28</sup> CLWSC Ex. 66.

<sup>29</sup> ED-KA-6. The ED submitted ED-KA-6 with his prefiled testimony and that exhibit was admitted. The ED's witness, Kamal Adhikari, revised ED-KA-6 during the hearing to correct a minor error, and the revised ED-KA-6 was also admitted into evidence, with the ED withdrawing the prefiled ED-KA-6. Tr. pp. 1310-1311. However, in his closing arguments, the ED revised ED-KA-6 again. As will be discussed below, that ALJs have excluded this exhibit from the evidentiary record, and it will not serve as a basis for the ALJs' analysis. The ALJs' citation to ED-KA-6 refers to the exhibit that was revised and admitted during the evidentiary hearing.

<sup>30</sup> The differences between the ED's and CLWSC's original cost for the post-acquisition assets will be addressed in another section of this PFD.

<sup>31</sup> The ALJs obtained this amount for the ED's "total original cost" from ED-KA-6, prepared by Mr. Adhikari. This amount varies from the "plant-in-service/gross plant (original cost)" in the previous table, which the ALJs obtained from ED-DL-5, p. 3, prepared by Ms. Loockerman. The reason for the difference is that Ms. Loockerman's "plant-in-service" of \$64,206,901 in ED-DL-5 reflects adjustments made by Mr. Adhikari in ED-KA-6 after his determination of the "total original cost" of \$68,775,390 for the three categories of CLWSC assets.

The issues involving CLWSC's rate-base valuation are numerous and complex. In this section of the PFD, the ALJs will present the applicable law and the parties' positions on the various rate-base issues and will analyze each issue involving CLWSC's rate-base valuation and make a recommendation on the rate-base value.

## **B. Applicable Law**

Chapter 13 of the Texas Water Code governs this proceeding, and several definitions create important distinctions. The term "utility" includes an IOU, but does not include a water supply corporation. Many of the provisions in chapter 13 apply to "utilities" and, therefore, do not apply to water supply corporations. This distinction is at the root of many of the disputes regarding CLWSC's rate-base valuation.

Specifically, section 13.002(19) defines a "retail public utility" as "any person, corporation, public utility, water supply or sewer service corporation, municipality, political subdivision or agency operating, maintaining, or controlling in this state facilities for providing potable water service or sewer service, or both, for compensation."<sup>32</sup> This includes a water supply corporation. However, section 13.002(23) does not include water supply corporations with the definition of the synonymous terms "water and sewer utility," "public utility," or "utility," which it defines as:

[A]ny person, corporation, cooperative corporation, affected county, or any combination of these persons or entities, *other than a municipal corporation, water supply or sewer service corporation*, or a political subdivision of the state . . . owning or operating for compensation in this state equipment or facilities for the transmission, storage, distribution, sale, or provision of potable water to the public . . . .<sup>33</sup>

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<sup>32</sup> Tex. Water Code § 13.002(19).

<sup>33</sup> Tex. Water Code § 13.002(23) (emphasis added).

Ratemaking for utilities is governed by chapter 13, subchapter F of the Texas Water Code.<sup>34</sup> Under this subchapter, the TCEQ is required to “ensure that every rate made, demanded, or received by any utility . . . shall be just and reasonable.”<sup>35</sup> In a ratemaking proceeding, the utility bears the burden of proof to show that the proposed rates are just and reasonable.<sup>36</sup>

A utility’s rates are based upon the utility’s cost of service.<sup>37</sup> A utility’s cost of service is comprised of two components: allowable expenses and return on invested capital.<sup>38</sup> The term “invested capital” is also referred to as the “rate base.” To determine a utility’s rate base, the original cost of the assets must be calculated.<sup>39</sup> Section 13.185(b) of the Texas Water Code addresses original cost and provides:

Utility rates shall be based on the original cost of property used by and useful to the utility in providing service, including, if necessary to the financial integrity of the utility, construction work in progress at cost as recorded on the books of the utility. . . . Original cost is the actual money cost or the actual money value of any consideration paid, other than money, of the property at the time it shall have been dedicated to public use, whether by the utility that is the present owner or by a predecessor, less depreciation. Utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in invested capital.<sup>40</sup>

The TCEQ’s rules also provide that certain items may not be included in a utility’s rate base. For instance, accumulated reserve for deferred federal income taxes, CIAC, and other sources of cost-free capital as determined by the TCEQ are not included in the rate base.<sup>41</sup>

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<sup>34</sup> Tex. Water Code § 13.181(a).

<sup>35</sup> Tex. Water Code § 13.182(a).

<sup>36</sup> Tex. Water Code § 13.184(c).

<sup>37</sup> 30 Tex. Admin. Code § 291.31(a).

<sup>38</sup> 30 Tex. Admin. Code § 291.31(a). The ALJs discuss CLWSC’s allowable expenses in another section of this PFD.

<sup>39</sup> 30 Tex. Admin. Code § 291.31(c)(2).

<sup>40</sup> *See also*, 30 Tex. Admin. Code § 291.31(c)(2)(B)(i).

<sup>41</sup> 30 Tex. Admin. Code § 291.31(c)(3).

### C. Original Cost

In this case, the fundamental issue in calculating CLWSC's rate base is the original cost of the pre-acquisition assets for which there is insufficient supporting documentation. The parties have very different positions on how that original cost should be determined.

#### 1. CLWSC

Since acquiring the WSC, CLWSC has filed three rate applications.<sup>42</sup> In the first two, filed in 2007 and 2008, CLWSC's used the booked costs of its used and useful assets to support its rate request. In the 2008 application, CLWSC also requested that the TCEQ make a rate-base determination, and CLWSC relied on its booked values to establish original cost.<sup>43</sup> The ED had concerns about the reliability of the booked costs, and CLWSC agreed to perform a trending study as part of the settlement of the 2008 rate case. The settlement agreement is handwritten and states:

The [ED and CLWSC] agree that the utility can provide additional documentation supporting a rate base determination in its next rate case. Sufficient documentation for utility plant items acquired in the original purchase of the system will take the form of a trending analysis using current replacement cost procedure and appropriate cost indices consistent with and so long as the documentation complies with Commission's rules.<sup>44</sup>

Based on its recollection of the settlement agreement, CLWSC contends that this language means that a trending study would be used to determine the original cost of its plant-in-service in calculating its rate base.

CLWSC cites to section 13.185(b) of the Texas Water Code and claims that original cost is the "gold standard" for ratemaking. CLWSC maintains that in determining rate base, a utility

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<sup>42</sup> CLWSC filed its first two rate applications in 2007 (CLWSC Ex. 5) and in 2008 (CLWSC Ex. 6).

<sup>43</sup> Tr. pp. 238-239.

<sup>44</sup> CLWSC Ex. 7, p. 711.

must determine the actual money paid for the asset at the time it was first dedicated to public use, and there is no other methodology for calculating a utility's rate base. According to CLWSC, in the absence of invoices and other documentation, the trending study in this case accomplishes this purpose and meets the "gold standard."

CLWSC asserts that the original cost derived from the trending study should be incorporated into its rate base for several reasons. According to CLWSC, the ED's witness in this case, Mr. Adhikari, recommended in the 2008 rate case that CLWSC perform a trending study for acquired assets that lacked supporting original-cost information.<sup>45</sup> The ED is now recommending that the trending study be used as "back-up documentation to support the numbers in the books of CLSWC," rather than for ratemaking purposes.<sup>46</sup> CLWSC argues that the ED is acting arbitrarily and capriciously by not accepting the trended values from the study that he required CLWSC to perform.<sup>47</sup>

CLWSC further argues that trending studies are commonly accepted in TCEQ rate cases. CLWSC's sponsoring witness for the trending study, Dr. Gebhard, testified that in a number of past cases trending studies have been relied upon to establish a utility's rate base when records of original cost at the time of installation, or dedication to public service, are non-existent or unreliable.<sup>48</sup>

CLWSC also maintains that the trending study provides the best available method of establishing original cost for the assets analyzed. According to CLWSC, there are problems in relying on the WSC's booked costs to establish the rate base for the IOU. Creation of the WSC through the consolidation of water systems resulted in the destruction of financial records, which may or may not have originally existed.<sup>49</sup> Further, CLWSC asserts that the differences in

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<sup>45</sup> CLWSC Closing, p. 32.

<sup>46</sup> CLWSC Closing, p. 32, quoting ED-KA-1, pp. 14-15.

<sup>47</sup> CLWSC Closing, p. 32.

<sup>48</sup> CLWSC Ex. D, p. 8.

<sup>49</sup> CLWSC Ex. 3, p. 1032.

accounting systems between a non-profit WSC and a for-profit IOU indicate that the WSC's booked costs cannot be used to establish original cost.

## 2. CEWR

CEWR makes two alternative arguments. Its primary position is that the "original cost" of the property acquired by CLWSC from the WSC is the purchase price paid by CLWSC for the property. CEWR asserts that CLWSC is the first "utility" to dedicate the pre-acquisition property to public use; therefore, the purchase price paid by CLWSC for the WSC's plant is the original cost of the pre-acquisition assets. In the alternative, CEWR argues that if the ALJs conclude that the original cost of the pre-acquisition assets is not CLWSC's purchase price, then the value of the assets must be set at the book value of the assets, less developer and customer contributions.

As previously stated, section 13.185(b) of the Texas Water Code defines original cost as the "actual money cost . . . paid . . . at the time [the property] shall have been dedicated to public use, whether by the utility that is the present owner or by a predecessor."<sup>50</sup> CEWR claims that the legislature's use of the word "utility" in section 13.185(b) is important to the issue of whose costs are determinative of original cost. It is not the actual money paid by the developer or the customer that determines original cost, but the actual money paid by the utility or a predecessor utility that determines original cost. According to CEWR, CLWSC is the first utility, and the original cost should be set at the purchase price CLWSC paid for the WSC's assets.

CEWR maintains that this construction of section 13.185(b) remedies many of the problems in this case. Since the WSC was not a "utility," it was not required to record plant additions at original cost, and there is no way to know whether the book value of any property owned by a non-utility reflects the original cost of the property. Also, CEWR claims that the Texas Water Code does not require non-utilities to account for contributions of property by

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<sup>50</sup> Tex. Water Code § 13.185(b).

customers or developers. Therefore, there can be no certainty as to what property owned by the WSC was donated or funded by contributions. CEWR maintains that the only way to avoid the problems created by the different statutory treatments of property owned by utilities and non-utilities is to interpret section 13.185(b) to fix the original cost at the time the property was first put into service by an IOU, regardless of whether it was previously operated by a non-utility.

Furthermore, CEWR argues that because the WSC was a member-owned entity, the WSC could never dedicate its property to public use. A WSC is a member-owned, non-profit corporation organized under chapter 67 of the Texas Water Code. CEWR contends that because the WSC could only provide service to its members, the WSC could not provide service to the general public, and the facilities owned by the WSC were not dedicated to public use.<sup>51</sup> Therefore, according to CEWR, the first time the facilities were dedicated to public service is when they were acquired by CLWSC.<sup>52</sup>

CEWR claims that CLWSC's position on original cost allows it to artificially inflate the amount of invested capital by claiming the trended net book value of the property, even though it paid substantially less than net book value and without an adjustment for donated property and customer contributions. CEWR argues that even CLWSC's expert, Mr. Loy, recognized this concern by testifying that any time a utility receives assets that it does not pay for, the utility should not include the value of those assets in rate base for the purpose of calculating a return.<sup>53</sup> CEWR claims that CLWSC simply refused to research the level of contributed assets because it would be too difficult.<sup>54</sup>

CEWR's expert witness, Ms. Heddin, testified that CLWSC paid a net \$16,523,000 inclusive of closing costs and fees for the pre-acquisition assets.<sup>55</sup> She testified that CLWSC

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<sup>51</sup> Tr. p. 745.

<sup>52</sup> Tr. p. 670.

<sup>53</sup> Tr. pp. 476-477.

<sup>54</sup> Tr. pp. 490-497.

<sup>55</sup> CEWR Ex. 1, p. 15.

paid \$5,523,000 in cash consideration with a payment of \$3.2 million to the WSC members.<sup>56</sup> CLWSC also assumed approximately \$19,900,000 in liability on the WSC's bonds issued by the TWDB. Because CLWSC received \$8,900,000 in cash and sinking funds from the WSC, Ms. Heddin calculated that CLWSC had \$16,523,000 in capital at risk from the purchase of the WSC.<sup>57</sup> Ms. Heddin testified that \$16,523,000 is a reasonable number to use for the purchase price because this is similar to the amount of \$16,542,000 shown as the purchase price in SJW Corp's Form 10-K.<sup>58</sup> This number is also significantly greater than the purchase price of \$14,719,436 identified by the WSC on its tax filing form regarding the acquisition of the WSC's assets.<sup>59</sup>

CEWR disputes CLWSC's assertions that it paid more for the assets of the WSC than is reflected in the money paid. CLWSC offered testimony that the members of the WSC benefited from the purchase for a variety of reasons, including CLWSC's ability to make needed capital investments, and CLWSC's agreement not to seek a rate increase for two years (stay-out provision).<sup>60</sup> CEWR claims that none of these benefits affects the purchase price paid for the assets regarding original cost because the benefits are not quantifiable.<sup>61</sup> Further, according to CEWR, the benefits provided little real benefit to the ratepayers. Regarding CLWSC's agreement not to raise rates for two years after acquisition, CLWSC would need at least a year to obtain sufficient operating experience to be able to file a rate case based on a historic test year.<sup>62</sup> Further, even though CLWSC agreed to make substantial investments to bring the water system into compliance, CLWSC is allowed to earn a return on all new capital investment, and most of

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<sup>56</sup> CEWR Ex. 1, p. 15.

<sup>57</sup> CEWR Ex. 1, p. 15 (\$5,523,000 (cash paid) + 19,900,000 (bond liability) – 8,900,000 (cash received) = \$16,523,000).

<sup>58</sup> CEWR Ex. 5, p. 66.

<sup>59</sup> CEWR Ex. 6, p. 78.

<sup>60</sup> Tr. p. 220.

<sup>61</sup> Tr. p. 1366.

<sup>62</sup> Tr. p. 226.

CLWSC's new capital investment was made after the expiration of the two-year rate change moratorium.<sup>63</sup>

In addition, Ms. Heddin also provided testimony on how to properly adjust the book value of the assets on CLWSC's books to reflect the purchase price, and she set out a procedure to determine annual depreciation. Ms. Heddin identified the adjusted net book value of the pre-acquisition assets as of March 31, 2010 (\$14,439,207) and the annual depreciation expense associated with these assets (\$477,376).<sup>64</sup> CEWR claims that those values have not been disputed.

In the event the ALJs do not agree that the original cost of the pre-acquisition assets is the price CLWSC paid for the WSC, CEWR takes the alternative position that the value of these assets must be set at the book value of the assets less developer- and customer- contributions. CEWR argues that if original cost is the price paid for the property when the property was dedicated to public use by either the WSC or a predecessor, then the invested capital calculation must reflect that the property donated to the WSC by developers and customers had an original cost of zero because the WSC paid nothing for the property.

CEWR also takes issue with the reliability of CLWSC's trending study. CEWR asserts that the trending study is not a better estimate of the original cost than the values contained in the WSC's audited financial records. CEWR claims that the evidence shows that the results of trending studies can be highly variable depending on when they were performed and who performed them.<sup>65</sup>

CLWSC performed two trending studies that are relevant to this proceeding. In 2007, CLWSC conducted the first trending study for the Rancho del Lago (RDL) water system that it

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<sup>63</sup> Tr. p. 225.

<sup>64</sup> CEWR Ex. 1, p. 23.

<sup>65</sup> CEWR Ex. 1, p. 15.

acquired after it acquired the WSC assets.<sup>66</sup> This first trending study was performed before CLWSC acquired the developer-owned RDL system. According to Ms. Heddin, the values in the 2007 RDL trending study correspond to the values shown in the STM application for the transfer of the RDL water system to CLWSC. In 2010, CLWSC conducted a second trending study, and this is the trending study CLWSC relies on to estimate the original costs of its pre-acquisition assets.

Ms. Heddin compared the values found by both trending studies for various sizes of PVC pipe installed in 1984. She found that the values in the 2010 trending study exceeded the values in the 2007 trending study by as much as 47% for all pipe other than the two-inch diameter PVC pipe.<sup>67</sup> Therefore, the original cost estimates in the 2007 trending study are significantly different from the original cost estimates in the 2010 trending study for the same type of assets with the same year of installation. Given the variances in the values in PVC pipe found by the two trending studies, CEWR claims that the WSC's audited financial records provide a more reliable estimate of original cost than CLWSC's unreliable trending study.

Another problem with the trending study, according to CEWR, is that most of the trended assets are of types commonly donated to utilities by developers or funded by customer contributions such as distribution lines, service lines, taps, meters, etc.<sup>68</sup> CEWR maintains that the original cost of donated property should be zero because the WSC paid nothing for that property. CEWR argues that CLWSC is attempting to use trending to inflate the rate base because the donated property should be excluded from the rate base. According to CEWR, trending studies should not set original cost when audited financial records are available and assets were donated to the utility or purchased with contributed funds.

In addition to its arguments regarding the original cost of the pre-acquisition assets, CEWR also takes issue with the inclusion of the trended original cost values for the RDL water

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<sup>66</sup> CEWR Ex. 3.

<sup>67</sup> CEWR Ex. 1, pp. 12-13, Table 3.

<sup>68</sup> CLWSC Ex. D, p. 13; Tr. pp. 764-765.

system. CLWSC acquired the RDL water system in 2008 for a purchase price of \$500,000.<sup>69</sup> According to CEWR, CLWSC estimated the replacement cost at an estimated installation date of the assets using the 2007 trending study at \$1,412,802 with a net book value at the time of the acquisition of \$1,087,556.<sup>70</sup> Because the RDL trending study is not part of the record, CEWR claims that CLWSC did not meet its burden of proof for the depreciation values of these assets.

CEWR asserts that because these assets were part of an IOU-to-IOU acquisition, the original cost of the property should be the price paid by RDL when the property was dedicated to public service. However, according to CEWR, the record contains no evidence as to what RDL originally paid for the property. Therefore, CEWR sees two options to estimate the original cost for the RDL assets: either rely on the 2007 trending study that is not in the record; or use the \$500,000 purchase price paid by CLWSC for the property.

According to CEWR, CLWSC made no effort to research RDL's records to determine original cost at the time that RDL acquired the property.<sup>71</sup> Since CLWSC has the burden of proof on this issue, it is CEWR's position that the original cost for the RDL property should be zero because CLWSC failed to meet its burden. However, CEWR speculates that neither the ALJs nor the TCEQ will adopt this result. Therefore, CEWR alternatively recommends that the original cost for RDL plant be set at the \$500,000 purchase price paid by CLWSC for the property.

### 3. OPIC

OPIC generally agrees with the position expressed by CEWR regarding CLWSC's rate base. OPIC takes the position that the term "predecessor" in section 13.185(b) of the Texas Water Code can only refer to a utility because a water supply corporation has no interest in earning a rate of return on invested capital. The interest protected in section 13.185(b) is

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<sup>69</sup> CLWSC Ex. 39, p. 630.

<sup>70</sup> CEWR Ex. 1, p. 25.

<sup>71</sup> CEWR Ex. 45; Tr. p. 712.

CLWSC's investment, which is easily quantifiable. According to OPIC, the trending study is unnecessary because the original cost of the pre-acquisition assets is the price paid by CLWSC, the first utility to donate the facilities to public use.

#### 4. ED

The ED asserts that the true “gold standard” for ratemaking is found in section 13.001(c) of the Texas Water Code, which provides that “[t]he purpose of [chapter 13] is to establish a comprehensive regulatory system that is adequate to the task of regulating retail public utilities to assure rates, operations, and services that are *just and reasonable to the consumers and to the retail public utilities.*”<sup>72</sup> The ED maintains that this legislative policy dictates that the best standard for original cost is an analysis of the invoices and accounting records documenting the flow of dollars through financial statements into plant-in-service, and CLWSC's trending study fails to take this into consideration. Further, the ED points out that 30 Tex. Admin. Code § 291.31(c)(3)(A)(v) requires that a utility may not earn a return on an investment it did not make.

Like CEWR, the ED asserts that original cost is the value paid by CLWSC when it purchased the assets from the WSC.<sup>73</sup> The ED argues that CLWSC paid approximately \$26,497,000 for assets worth \$31,221,457.<sup>74</sup> However, the ED recognizes that CLWSC also provided unquantifiable consideration, in addition to the discounted purchase price, by agreeing not to seek a rate increase for two years (the stay-out provision) and assuming a substantial, but unknown, amount of capital infusion to bring the WSC up to standards. Therefore, to recognize the additional, non-quantifiable consideration and the “bargain” purchase price, “the ED submits that the booked costs are the most appropriate approximation for original cost, rather than the lower sales price or the higher trended estimates . . . .”<sup>75</sup> The ED claims that this method of

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<sup>72</sup> ED Closing, p. 2 (emphasis in closing argument).

<sup>73</sup> ED Closing, p. 20.

<sup>74</sup> CLWSC Ex. 3, p. 1031; Tr. pp. 130-131.

<sup>75</sup> ED Closing, pp. 2-3.

determining original cost acknowledges the value of the stay-out provision and CLWSC's improvements to the WSC's water system by allowing CLWSC to depreciate the book values of the assets, where simply using the purchase price would not.

It is the ED's position that trending studies and booked costs are two different ways to arrive at the same result: an estimate of original costs. However, the ED takes issue with CLWSC's use of a trending study in this case. According to the ED, CLWSC's trending study would not lead to just and reasonable rates because it would allow CLWSC to increase its rate base by \$3.5 million that was not invested and give CLWSC a return on an additional \$3.5 million in original cost that it never made.<sup>76</sup>

The ED points out that in CLWSC's two previous rate cases, it used booked costs as the original costs.<sup>77</sup> Most importantly, in its second rate application in 2008, CLWSC sought a rate base determination based on those same booked costs it now argues should not be used to estimate original cost.<sup>78</sup> In the 2008 rate case, the ED had concerns about the WSC's booked values because, coupled with the lack of invoices and no description of the assets, the booked costs were \$4.7 million more than what CLWSC paid for the WSC's assets.<sup>79</sup> Therefore, the ED entered into the settlement agreement intending that the trending study would be used to support the WSC's booked costs. The ED did not intend for the trending study to be used as a substitute for those booked values, as CLWSC now advocates.

Further, the ED maintains that there are significant flaws in CLWSC's trending study. One problem is that the study fails to account for CIAC. The ED argues that by including CIAC-assets in the list of trended assets, customers would be paying twice for the same asset.

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<sup>76</sup> ED Closing, p. 4.

<sup>77</sup> CLWSC Ex. 5 & 6; Tr. pp. 223-225; Tr. pp. 238-240.

<sup>78</sup> Tr. pp. 238-240.

<sup>79</sup> According to the STM, CLWSC paid \$26,497,000 to acquire the WSC's assets with a net book value of \$31,221,457, a difference of \$4,724,457. CLWSC Ex. 3, p. 1031.

Next, the ED argues that while the WSC's booked costs may have lumped together different assets into one entry, the trending study would show separate assets with separate values. For example, the WSC's booked costs may include a \$5,000 value for land, including a fence. However, when CLWSC performed its inventory, Dr. Gebhard may have seen a fence on the land and listed that fence as a new asset, so that the trending study may have shown a \$5,000 value for the land and \$1,000 for the fence.

In the ED's opinion, another flaw with the trending study is that it fails to recognize the WSC's capitalization policy that treated all items under \$2,500 as expenses.<sup>80</sup> Since CLWSC's capitalization policy has a floor of \$1,000, the trending study would have misclassified items costing between \$1,000 and \$2,500 as assets instead of expenses that WSC's members would have already paid for through their rates.

In this case, the ED used CLWSC's trending study to verify that the booked costs were not overstated and to complete his list of assets. Therefore, the ED maintains that the trending study was used as contemplated in the settlement of the 2008 rate case. The ED's position is that CLWSC should not be allowed to use the trending study to inflate its rate base, and the original cost should be based on the value CLWSC paid at the time CLWSC first dedicated the assets to public use.

## 5. ALJs' Analysis

The ALJs agree with the parties that original cost based on actual invoices is the preferred method to establish original cost, but regulatory agencies have also approved other methods of estimating original cost in the absence of such invoices. Original cost based on a

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<sup>80</sup> ED-DL-34, p. 6.

reliable trending study is one way to determine original cost.<sup>81</sup> However, reliance on book values is yet another method of estimating original cost, as demonstrated by CLWSC in its first two rate applications. Regulatory agencies have also found that the purchase price is an acceptable method of establishing original cost.<sup>82</sup> As shown by these court and administrative cases, regulatory agencies have used different methods to establish the original cost of a utility's plant. Therefore, the ALJs conclude that they must determine which one of the proposed methods is the most reliable method to determine the original cost of the pre-acquisition assets, with original cost representing the cost of investment.<sup>83</sup>

Regarding the trending study, the ALJs are not convinced that CLWSC's study is the most reliable estimate of original cost. The witnesses for the ED and CEWR expressed concerns about the trending study, and the ALJs share those concerns, especially since CLWSC had the ability to rebut this testimony but did not.

The ALJs' first concern is that the trending study did not consider the WSC's \$2,500 capitalization policy. When cross-examined on this issue, Dr. Gebhard testified that he did not consider the different capitalization policies of the WSC and CLWSC in preparing his trending study.<sup>84</sup> He also conceded that if an asset was expensed and paid by the WSC members, the members would pay for that same asset again if CLWSC included it within its rate base.<sup>85</sup>

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<sup>81</sup> ED Reply, Att. 2, *Application of Quadvest, Inc. for a Water and Sewer Rate/Tariff Change*, SOAH Docket No. 582-03-2832, TCEQ Docket No. 2003-0242-UCR, Final Order, Aug. 16, 2004 (FOF No. 21); *Application of Oakridge Water Co. d/b/a Pine Springs Utils. for Authority to Increase Rates within Polk, Tyler, Hardin, Walker, San Jacinto, Trinity, and Liberty Counties*, P.U.C. Docket No. 3718, 1981 Tex. PUC LEXIS 4, 7 Tex. P.U.C. Bull. 673 (1981) (Staff's use of trending to establish original cost approved by PUC).

<sup>82</sup> *Suburban Util. Corp. v. Public Util. Comm'n*, 652 S.W.2d 358, 365 (Tex. 1983) (PUC used the purchase price paid by shareholders to the owners of a water utility as the original cost); *Application of Crest Util. Co. for Authority to Increase Water Rates within Harris County*, 1980 Tex. PUC Lexis 18; 6 Tex. P.U.C. Bull. 592 (1980) (PUC used purchase price instead of trended original cost with amortized negative acquisition adjustment).

<sup>83</sup> *Cf. State v. Public Util. Comm'n*, 883 S.W.2d 190, 200 (Tex. 1994) (original cost definition in the then-section 41(a) of the Public Utility Regulatory Act is "the cost of investment" to the utility that first dedicated the property to public use, regardless of subsequent transfers).

<sup>84</sup> Tr. pp. 793-794.

<sup>85</sup> Tr. p. 805.

A review of CLWSC Ex. 67 shows that approximately 174 assets listed in Column S have a trended original cost of less than \$2,500.<sup>86</sup> Some of these assets have exceeded their service lives, but many have not. Nevertheless, the WSC's members would have paid for a significant number of these assets as expenses, but CLWSC now includes them in its proposed rate base, calling into question the reasonableness of the trending study.

The ALJs also have concerns regarding the reliability of the trending study given the large variation in the trending values for similar assets of similar vintage. CLWSC performed two trending studies that are relevant to this case: one in 2007 that GDS conducted before CLWSC acquired the RDL water system, and one in 2010 that GDS conducted specifically for this rate case.<sup>87</sup> Dr. Gebhard testified that the two trending studies should have arrived at similar original costs for similar assets installed in the same year.<sup>88</sup> However, for the PVC pipe, he conceded that the two trending studies arrived at different original cost estimates for the same type of assets with the same years of installation. Ms. Heddin compared the different price per foot for PVC pipe from the two trending studies and made the following comparisons:<sup>89</sup>

	<b>2010 WSC Trended Value</b>	<b>2007 RDL Trended Value</b>	<b>2010 WSC Trended Value Percent Greater than 2007 RDL Trended Value</b>
<b>6" PVC Water Line</b>	\$7.72 per foot	\$6.39 per foot	20.77 %
<b>4" PVC Water Line</b>	\$7.23 per foot	\$4.91 per foot	47.19 %
<b>3" PVC Water Line</b>	\$4.83 per foot	\$3.93 per foot	22.66 %
<b>2" PVC Water Line</b>	\$2.65 per foot	\$3.44 per foot	-22.90 %

<sup>86</sup> CLWSC Ex. 66, p. 1 of 70 (9 items less than \$2,500); p. 5 of 70 (5 items less than \$2,500); p. 8 of 70 (3 items less than \$2,500); p. 11 of 70 (14 items less than \$2,500); p. 14 of 70 (4 items less than \$2,500); p. 15 of 70 (11 items less than \$2,500); p. 23 of 70 (17 items less than \$2,500); p. 26 of 70 (5 items less than \$2,500); p. 30 of 70 (4 items less than \$2,500); p. 32 of 70 (13 items less than \$2,500); p. 33 of 70 (21 items less than \$2,500); p. 34 of 70 (11 items less than \$2,500); p. 47 of 70 (7 items less than \$2,500); p. 51 of 70 (43 items less than \$2,500); and p. 53 of 70 (7 items less than \$2,500).

<sup>87</sup> Tr. p. 781. George Freitag of GDS conducted the 2007 RDL trending study. CEWR Ex. 3. Dr. Gebhard, also of GDS, conducted the trending study for the pre-acquisition assets in 2010 for this rate case.

<sup>88</sup> Tr. p. 781.

<sup>89</sup> CEWR Ex. 1, p. 11.

Dr. Gebhard testified that the differences in the two numbers probably resulted from different replacement costs used by the two persons who performed the two trending studies.<sup>90</sup> He characterized the differences in the estimated original costs as a result of what the person who conducted the trending study knew at the time. However, Dr. Gebhard also testified that when trending studies are performed at different times for assets with the same date of installation, the trended values should be similar regardless of when the trending study was done.<sup>91</sup> But that did not occur in this case. Two studies trending similar assets with similar installation dates made significantly dissimilar estimations of original cost. To the ALJs, this large variation in the original cost of the PVC pipe indicates that CLWSC's current trending study is not a reliable estimate of original cost when compared to other methods because the valuation is very dependent on the judgment of the person who performed the study.

Although CLWSC attacked Ms. Heddin's credentials as an expert witness, CLWSC did not rebut her analysis regarding the variation in trended values.<sup>92</sup> Nor did CLWSC's cross-examination of Ms. Heddin elicit any flaws in her analysis of the variation in original cost estimates for the PVC pipe trended in the two trending studies. Therefore, the evidence shows that Ms. Heddin pointed out serious concerns with the results of CLWSC's trending study that directly relates to the study's reliability.

In defense of its trending study, CLWSC pointed to Dr. Gebhard's testimony in which he stated that two experts could prepare two trending studies and both could be right, even if they used different replacement values in the exercise of their professional judgment.<sup>93</sup> This answer illustrates that original costs estimated by a trending study can be highly variable, depending on the expert and his assumptions. The variability demonstrated in this case for one asset group

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<sup>90</sup> Tr. p. 781.

<sup>91</sup> Tr. p. 780.

<sup>92</sup> On February 20, 2012, CLWSC objected to Ms. Heddin's prefiled testimony on the basis that she was not qualified to give expert opinion, and the ALJs overruled CLWSC's objections during the March 21, 2012 prehearing conference. However, CLWSC asked for Ms. Heddin's "expert opinion" regarding the rate of return in this case. Tr. p. 959.

<sup>93</sup> Tr. pp. 782-784.

calls into question the reliability of the entire trending study, including more complex assets such as wells, real estate, and structures. If there can be such variation for simple assets such as PVC pipe, how much variation can be found in original cost estimates for complex assets? The ALJs conclude that, given the concerns with the trending study, especially the demonstrated large variation in trended values, the trending study prepared by CLWSC for the pre-acquisition assets is not the best estimation of the original cost of the assets.

The ALJs also have concerns with using the price CLWSC paid to purchase the WSC's assets to estimate original cost. The ED, OPIC, and CEWR argue that purchase price is the appropriate estimation of the original cost of the pre-acquisition assets at issue. Using CLWSC's purchase price in the rate base valuation is the simplest method to estimate original cost because it would eliminate the CIAC and cost-free capital issues.<sup>94</sup> However, as pointed out by the ED, using the purchase price would be problematic because there is no asset list and it would be difficult to assign an original cost to each asset for depreciation purposes. It would also be difficult to use the purchase price because there are different purchase prices in this evidentiary record.<sup>95</sup> Further, CLWSC is not the first utility to dedicate the assets to public use because the WSC was formed from a collection of mom-and-pop utilities. For these reasons, the ALJs do not recommend that the purchase price be used as the estimate of the original cost of CLWSC's pre-acquisition assets.<sup>96</sup>

As an alternative to using the purchase price, CEWR suggests that the original cost for each asset acquired through developer- and customer- CIAC be valued at zero. In terms of customer-CIAC, 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv) tends to support CEWR's alternative position because the rule provides that "utility property funded by customer

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<sup>94</sup> These issues will be discussed in another section of this PFD.

<sup>95</sup> CLWSC Ex. 3, p. 1031 ("total purchase price" of \$26,497,000); CEWR Ex. 1, p. 15 ("net capital at risk" for the purchase of the WSC is \$16,523,000); CEWR Ex. 5, p. 66 ("total purchase price" for the net assets of WSC included \$5,523 in cash and discharge of approximately \$19,900 of bonds); CEWR Ex. 6 ("total sales price" of \$14,719,436).

<sup>96</sup> Regarding the original cost for the plant for the Rancho del Lago water system, CEWR proposed a similar approach to the valuation of those assets as it did for the pre-acquisition assets.<sup>96</sup> There is very little evidence or discussion on this issue. The ALJs decline to recommend the rationale proposed by CEWR for the valuation of the RDL water system assets because it is similar to the approach rejected by the ALJs above.

contributions in aid of construction . . . may not be included in *original cost* or invested capital . . . .”<sup>97</sup> This is also consistent with section 13.185(j) of the Texas Water Code which prohibits depreciating customer-CIAC. However, a utility is allowed to depreciate plant donated from a developer.<sup>98</sup> Therefore, plant attributable to developer-contributed property must be included in the original cost and depreciated; it cannot have an original cost of zero as advocated by CEWR.

CEWR attached new schedules to its closing arguments that amortize the amounts of contributed property based on the weighted average useful life of CLWSC’s pre-acquisition assets. However, CLWSC objected to these schedules because it has not been afforded the opportunity to cross-examine Ms. Heddin on these new schedules. The ALJs agree that CEWR’s new schedules are new evidence that calculates depreciation on the total amount of CIAC and not on the original cost of an individual asset. This is not simply a summation of the evidence, but a newly-proposed valuation of CLWSC’s rate base. The ALJs will not consider the schedules attached to CEWR’s closing arguments.

As an alternative to its new amortization proposal for the pre-acquisition assets, CEWR advocates that the entire amount of donated property and CIAC shown on the WSC’s financial statements be removed from the rate base with no depreciation allowed and analyzed in a subsequent rate case. The ALJs agree with CLWSC that postponing that decision to a later case would not change the lack of documentation.

Yet another method of estimating original cost was presented by the ED. Mr. Adhikari, the ED’s witness, took the values provided by CLWSC for every CLWSC asset, both pre- and post- acquisition, both trended and non-trended, to estimate original cost.<sup>99</sup> He compared CLWSC’s trended, pre-acquisition original cost values with the booked values for those pre-acquisition assets. He determined that the trending study supported the booked values, and he

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<sup>97</sup> Emphasis added.

<sup>98</sup> Tex. Water Code § 13.185(j).

<sup>99</sup> Tr. p. 1256; ED-KA-2.

calculated that the overall difference between the booked values and CLWSC's trended original cost was \$3,536,805.<sup>100</sup> He then subtracted \$3,536,805 from Staff's estimate of the original cost for all of CLWSC's plant to arrive at the Staff's recommended adjusted, original cost of \$64,206,901. To calculate depreciation, Mr. Adhikari determined that the difference of \$3,536,805 is 5.14% of the total estimated original cost of all of CLWSC's assets of \$68,775,390.<sup>101</sup> He then adjusted the annual and accumulated depreciation by 5.14% to calculate the net book value of CLWSC's assets.

In his closing arguments, the ED modified his treatment of depreciation from what Mr. Adhikari had recommended at the hearing, "[a]fter hearing the evidence at trial."<sup>102</sup> Instead of deducting \$3,536,805 from the total original cost for all of CLWSC's assets, the ED recommended that only the annual depreciation for the trended assets should be adjusted. Mr. Adhikari revised his ED-KA-2 by "decreas[ing] the annual depreciation amounts in the [ED-KA-2 Depreciation Analysis] for each pre-acquisition asset that [was] trended by the same percentage as the difference between the [original cost] shown by the booked costs and the trending estimations of [original cost] for the total of those same assets."<sup>103</sup> The ED claims that with his revised depreciation analysis attached to his closing arguments, "the future annual depreciation of each asset can be consistently applied."<sup>104</sup>

CLWSC objected to the ED's revised schedules attached to his closing arguments, and the ALJs agree that these schedules present new evidence. The revisions appear to change Mr. Adhikari's prefiled testimony and his exhibits, and the ALJs have not had the benefit of testimony to fully understand the changes. Although it appears that Mr. Adhikari's revised schedules would result in a higher rate base, CLWSC has not had the opportunity to review these revised schedules and cross-examine the ED's witness. For this reason, the ALJs will only

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<sup>100</sup> ED-KA-6 (revised-trended \$10,349,699 – per book-trended \$6,812,894 = \$3,536,805).

<sup>101</sup> ED-KA-1, p. 11; ED-KA-6.

<sup>102</sup> ED Closing, p. 29.

<sup>103</sup> ED Closing, p. 29.

<sup>104</sup> ED Closing, pp. 29-30.

consider those exhibits admitted into evidence, even though Mr. Adhikari's revisions may prove helpful in future rate cases and purport to increase CLWSC's net plant by \$1,059,247.<sup>105</sup>

The ALJs agree with the ED that, in this case, the use of the booked values is a better estimate of original cost of the pre-acquisition assets than the estimates derived from CLWSC's trending study. As previously stated, the ALJs are not convinced of the reliability of the trending study used in this case. Also, the actions of CLWSC provide the most compelling evidence that the WSC's booked costs are sufficiently reliable to estimate original cost in this proceeding. In its first two rate applications, CLWSC relied on these same booked values to estimate the original cost of the WSC's assets for ratemaking purposes.<sup>106</sup> Had the second rate case been approved as requested in the 2008 application, CLWSC would have had a rate base determination based on those same booked values.<sup>107</sup> Furthermore, in this case, CLWSC also used booked values to estimate the original cost of those pre-acquisition assets funded by the TWDB because there was sufficient documentation to support those booked values.<sup>108</sup> CLWSC's actions have demonstrated that there is flexibility in estimating original cost and the WSC's booked values provide a reliable method of establishing original cost.

The ALJs agree with the ED that the trending study provides a complete asset list that supports the booked values shown on the WSC's audited financial statements. The ALJs conclude that the ED's method is a more reliable way of estimating the original cost of the trended, pre-acquisition assets, than the methods proposed by CLWSC and CEWR. Therefore, the ALJs' recommend that the original cost for all of CLWSC's assets should be \$64,206,901 as calculated by the ED.<sup>109</sup>

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<sup>105</sup> Compare ED-KA-2 admitted with prefiled testimony, (net plant \$38,153,363), with ED-KA-2 attached to ED closing arguments, (net plant \$39,212,610).

<sup>106</sup> Tr. pp. 223-225, 238-240, & 429; see CLWSC Exs. 5 & 6.

<sup>107</sup> Tr. pp. 238-240.

<sup>108</sup> Tr. pp. 1338-1339.

<sup>109</sup> ED-KA-6.

## D. CIAC

Another issue in the determination of the rate base is whether CLWSC included CIAC within its valuation of invested capital. Both the Texas Water Code and the TCEQ's rules expressly prohibit the inclusion of CIAC in a utility's rate base. Section 13.185(b) of the Texas Water Code provides that "[u]tility property funded by explicit customer agreements or [CIAC] such as surcharges may not be included in invested capital."<sup>110</sup> The rules also state that CIAC will not be included in a utility's overall rate base, except for good cause.<sup>111</sup>

It is undisputed that CLWSC properly excluded CIAC from its rate base for the post-acquisition assets. The issue of CIAC in CLWSC's rate base focuses solely on the pre-acquisition assets for which there is insufficient documentation.

### 1. CLWSC

CLWSC argues that there is no pre-acquisition CIAC to deduct from CLWSC's rate base. CLWSC claims that under the regulatory rules for water supply corporations, these non-profits take contributions from customers or other donated property and treat it as income, and the contributed property is transferred to the equity account of the water supply corporation on the balance sheet. Therefore, according to CLWSC, each contribution becomes part of each member's equity in the member-owned water supply corporation. CLWSC stated that this is how the WSC treated CIAC on its books, and the WSC did not track the CIAC and tie it to a specific plant asset. Further, the WSC booked donated property at its fair market value, and not at its original cost, thereby the use of booked costs for an estimation of original cost does not meet the "actual money paid" standard for original cost found in section 13.185(b) of the Texas Water Code.

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<sup>110</sup> See also, 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv).

<sup>111</sup> 30 Tex. Admin. Code § 291.31(c)(3)(A)(iv).

Conversely, IOUs are required to track each individual asset acquired through CIAC. There are two types of CIAC: (1) customer-CIAC; and (2) developer-CIAC. CLWSC states that in a typical situation, customer-CIAC represents cost-free capital to the IOU, and depreciation on customer-CIAC is excluded from a utility's rate base.<sup>112</sup> However, unlike customer-CIAC, an IOU may include in its cost of service a depreciation expense on developer-CIAC.<sup>113</sup>

Because of the differences in accounting systems, CLWSC maintains that any CIAC booked by the WSC will not reflect CIAC amounts equivalent to what an IOU's books would have reflected. For example, the WSC booked donated property at its fair market value, not its original cost. In addition, there is no way to track retirements or sales of CIAC assets, and there is no reliable amortization/depreciation life that can be used to eliminate CIAC from the books. CLWSC also argues that every plant asset of a water supply corporation could be considered contributed since its members owned and controlled all the assets.

In addition to the accounting problems, CLWSC argues that the transfer of CIAC from the WSC to CLWSC was not part of the acquisition deal between the two entities. The asset purchase agreement (the Agreement) was approved by the WSC members, 76.3% to 23.7%, and the Agreement did not include the transfer of CIAC for pre-acquisition assets. After executing the Agreement, CLWSC and the WSC jointly filed an STM application with the TCEQ and specifically stated that the amount of CIAC for the WSC assets being transferred was zero.<sup>114</sup> CLWSC claims that the WSC members willingly gave up their equity stake in the member-owned WSC. CLWSC also argues that the \$3.2 million that was distributed to the WSC members was their compensation for the CIAC.

CLWSC further maintains that the WSC's records regarding CIAC are unreliable. The WSC did not have original cost invoices for those IOUs it acquired, and there are no records

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<sup>112</sup> Tex. Water Code § 13.185(b).

<sup>113</sup> Tex. Water Code § 13.185(j).

<sup>114</sup> CLWSC Ex. 3, p. 1031.

from those previous IOUs identifying which assets were acquired through CIAC. Moreover, most of the assets of those prior IOUs, if still used and useful, have been fully depreciated.<sup>115</sup>

Finally, CLWSC characterizes the parties' arguments regarding CIAC as collateral attacks on the Agreement and the TCEQ's order approving the STM application. The TCEQ approved the STM application several years ago, and the recognition of CIAC was not part of the acquisition. According to CLWSC, the ED approved the CIAC amount in the STM order and the terms of the transaction cannot be collaterally attacked in this rate proceeding.

## 2. CEWR

CEWR asserts that no adjustments for CIAC are necessary if Tex. Water Code § 13.185(b) is applied according to the interpretation that the "original cost" of that property is the purchase price paid by CLWSC. Therefore, whether the WSC received CIAC is not relevant to the determination of the original cost. Alternatively, if trended values are used to estimate original cost, CEWR maintains that the recorded value for all property donated to the WSC or funded by customer contributions must be removed from the rate base since the original cost of such property is zero because the WSC paid nothing for the property.

CEWR reviewed the WSC's financial statements for the years 1995 through 2006. As result of this review, CEWR identified \$13,828,072 in donated property or customer contributions.<sup>116</sup> This figure included donated property, tap fees, line extension fees, membership fees, and equity buy-in fees, which are typically paid for by a water supply corporation's members. The issue then becomes whether the plant-in-service list needs to be adjusted to remove property that was donated to the WSC or funded by contributions from the WSC's customers. According to CEWR, the relevant inquiry is what the WSC paid for the property, not how the WSC valued the property on its books.

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<sup>115</sup> CLWSC Closing, p. 42.

<sup>116</sup> CEWR Closing, pp. 27-28.

Regarding CLWSC's argument that it purchased the equity of the WSC's members, CEWR claims that nothing in section 13.185(b) of the Texas Water Code indicates that the original cost of an asset changes in response to subsequent transactions. In other words, the original cost of a donated asset is zero, and that original cost does not change because the asset is later sold for more than zero.

Further, CEWR asserts that CLWSC did not purchase the equity of the WSC members, but purchased the WSC's assets.<sup>117</sup> CLWSC paid the WSC \$3.2 million and assumed the debt of the WSC in exchange for the assets of the utility.<sup>118</sup> Once the funds were paid, the WSC voted to dissolve and to distribute its remaining assets to its members. Ms. Heddin testified that these payments to the members were not based on the amount of any contributions they may have been made to the WSC, but were based on the member's average water usage over the previous two years.<sup>119</sup> Therefore, CEWR maintains any payment to a member was not related to any CIAC paid by that member to the WSC. Further, CEWR argues that there is nothing in the record showing that any developer was repaid for its donated property, although developer-donated property must be excluded from the rate base because its original cost is zero.

Regarding the WSC's and CLWSC's different accounting treatments for CIAC, CEWR disagrees with CLWSC's position that because the WSC did not maintain a balance sheet for contributed capital, CIAC cannot be excluded from rate base because there is no way to determine which assets are CIAC. CEWR argues that different accounting approaches between an IOU and a water supply corporation only make it more difficult to determine what assets can or cannot be included in a utility's rate base.

Further, CEWR argues that whether CIAC was reflected on a balance sheet as a contribution or as member equity does not affect CLWSC's burden to properly account for

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<sup>117</sup> CLWSC Ex. 3, p. 1348; Tr. p. 65; Tr. p. 186.

<sup>118</sup> CEWR Closing, p. 28. This appears to conflict with Ms. Heddin's testimony that CLWSC paid \$5,523,000 in "cash consideration." CEWR Ex. 1, p. 15.

<sup>119</sup> CEWR Ex. 1, p. 21.

CIAC. CEWR claims that CLWSC made no attempt to review the WSC's accounting records and, therefore, did not meet its burden of proof on the issue. For example, Ms. Heddin reviewed the records and determined that the WSC had received \$13,828,072 in donated property and customer contributions. Prior to the acquisition, Dr. Gebhard reviewed the WSC's records and found that the WSC had received \$11,097,000 in CIAC.<sup>120</sup> CEWR asserts that the ratepayers should not have to suffer because of CLWSC's lack of effort in accounting for CIAC and donated property identified by both Dr. Gebhard and Ms. Heddin from the WSC's financial records.

Regarding the lack of identified contributed assets, CEWR asserts that it was CLWSC's burden to identify specific property resulting from CIAC to properly depreciate or amortize the contributed amount along with the associated property. CEWR claims that CLWSC spent an enormous amount of money on a trending study to estimate the original cost of pre-acquisition assets, but chose not to spend any money or expend any effort to identify and properly account for contributions. To remedy this failure to meet its burden of proof, CEWR argues that at least \$13,828,072 should be removed from CLWSC's rate base without being amortized over time. Alternatively, CEWR proposes that amortization could be determined using the weighted service life of the acquired assets.

### 3. OPIC

Regarding CIAC, OPIC argues that the use of the purchase price as the original cost of the CLWSC's property eliminates any concern over whether the rate base contains CIAC. Therefore, the CIAC is adequately addressed if the purchase price is used to establish the rate base.

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<sup>120</sup> CLWSC Ex. 39, p. 630.

#### 4. ED

The ED contends that given the differences between what CLWSC paid for the WSC and the WSC's net book value, it is likely that certain assets transferred in the sale of the WSC had already been paid for by the WSC's members. Further, the ED disagrees with CLWSC's position that it paid for the contributed property because the WSC recorded CIAC as income on the income statement of the WSC, thereby reducing the rates the members paid. According to the ED, if the WSC was subsidizing its rates through the receipt of CIAC, then there would not have been an increase in the WSC's assets. However, the WSC did record an increase in net assets of \$2.8 million in 2005 and \$1 million in 2004, indicating that the WSC did not book the CIAC as income. The ED notes that, other than the speculation of the CLWSC witnesses, there is no evidence indicating how the WSC set its rates.

#### 5. ALJs' Analysis

The estimation of original cost is only one part of the determination of a utility's invested capital. As with its original cost estimation, the ALJs have concerns with the inclusion of CIAC in CLWSC's rate-base valuation.

The TCEQ requires that "utility property funded by explicit customer agreements or customer contributions in aid of construction . . . may not be included in original cost or invested capital . . ." <sup>121</sup> "[A] utility is not allowed to earn a rate of return on property acquired from or paid for by a ratepayer." <sup>122</sup> To allow a utility to earn a return on CIAC would be unjust since customers would be paying twice for the same property. <sup>123</sup> CLWSC witness, Mr. Loy, testified

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<sup>121</sup> 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv).

<sup>122</sup> *Sunbelt Utils. v. Public Util. Comm'n*, 589 S.W.2d 392, 393 (Tex. 1979) (utility system donated by developer who recovered the cost of the system from the sale of lots was properly excluded from rate base because the customers should not pay twice for the utility system; first when they bought the lots, and second, when they paid their water bills).

<sup>123</sup> *Sunbelt Utils. v. Public Util. Comm'n*, 589 S.W.2d at 395 (quoting *Princess Ann Util. Co. v. Commonwealth ex rel. S.C.C.*, 179 S.E. 2d 714 (Va. 1971)).

that customer- and developer- CIAC is excluded from the rate base because the utility has not made an investment upon which it should earn a return.<sup>124</sup>

CLWSC maintains that it paid the members of the WSC for all of their assets; therefore, there is no CIAC to deduct from its rate base. However, the ALJs do not agree with CLWSC's assessment of the CIAC issue. CLWSC bought the assets from the WSC, not its members.<sup>125</sup> It was only through the WSC dissolution process that the members received any money. Further, CLWSC does not direct the ALJs to the language in the Agreement that discusses the conveyance of CIAC, and the ALJs could find none. Therefore, the Agreement is silent on the issue of CIAC, and is no indication of the parties' intent one way or another on the issue.

In addition to its assumption of the WSC's debt and other consideration, CLWSC paid \$3.2 million to the WSC for the assets.<sup>126</sup> However, upon dissolution, the WSC paid its members according to their water usage over a two-year period,<sup>127</sup> and there is no correlation between the members' contributions to the WSC and the money they received through the dissolution process. If CLWSC earns a return on its invested capital that includes the members' CIAC, the WSC members would be paying twice for the property: first, when they contributed the property to WSC; and second, when they pay their water bills based on rates allowing a return on CIAC.

Furthermore, CLWSC appears to be arguing that two parties to a contract can change the character of property that is defined by state law. However, the fact that CLWSC and the WSC did not provide for CIAC in their Agreement does not change the character of CIAC. The TCEQ's rules expressly provide that "utility property funded by explicit customer agreements or customer contributions in aid of construction . . . *may not be included in original cost or invested*

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<sup>124</sup> CLWSC Ex. C, p. 13.

<sup>125</sup> CLWSC Ex. 3, p. 1348; Tr. pp. 65 & 186.

<sup>126</sup> CLWSC Ex. 3, p. 1352.

<sup>127</sup> CLWSC Ex. 3, p. 1234 (According to the WSC, the purchase of \$3.2 million would be distributed to the members "in an amount equivalent to about one year's water bill based on average water usage over the previous two years.").

*capital . . .*”<sup>128</sup> By referring to original cost, the rule looks to the time the asset was first dedicated to public use to determine if the asset was acquired with CIAC. CLWSC and the WSC cannot change this requirement by agreement.<sup>129</sup>

CLWSC also argues that the zero transfer of CIAC from the WSC to CLWSC is mandated because the two entities use different accounting systems. The issue of the differences in accounting systems does not change the character of property; it only makes it more difficult to properly exclude CIAC from the rate base.

CLWSC further argues that the WSC’s records are unreliable, and it cannot be determined which WSC assets were derived from CIAC. Again, this goes to whether it will be difficult to calculate and exclude CIAC from the rate base. This may present good cause to include CIAC in the rate base, as provided by 30 Tex. Admin. Code § 291.31(c)(3)(A)(iv), but the alleged unreliability of the WSC’s records does not change the character of property acquired by CIAC.

The ALJs are also not persuaded by CLWSC’s argument that the CIAC issue is a collateral attack on the STM. The purpose of the STM process is to determine whether an acquiring utility has adequate financial, managerial, and technical capability to provide continuous and adequate service.<sup>130</sup> Before the effective date of an acquisition of a water system, a utility or water supply corporation must seek approval of the acquisition from the TCEQ. The TCEQ may require the person acquiring the water system to demonstrate adequate financial, managerial, and technical capability, and the agency must determine whether the acquisition serves the public interest.<sup>131</sup> Section 13.301 of the Texas Water Code does not provide for the establishment of a utility’s rate base through the STM approval process, and the

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<sup>128</sup> 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv) (emphasis added).

<sup>129</sup> By stating that customer-CIAC may not be included in original cost, 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv) contradicts the testimony of CLWSC’s witnesses who testified that CIAC is included within the computation of original cost, and then subtracted elsewhere in the rate-base calculation. Tr. p. 613-616; CLWSC Ex. 62.

<sup>130</sup> Tex. Water Code § 13.301.

<sup>131</sup> Tex. Water Code § 13.301(b) & (d).

value of CIAC transferred from the WSC to CLWSC was, therefore, not adjudicated through the approval of the STM application. Clearly, the issues in an STM proceeding under Tex. Water Code § 13.301 are different from the issues in a ratemaking application under Tex. Water Code § 13.185. However, assuming *arguendo* that the amounts in the STM application were approved through the STM process and cannot now be changed or disputed, then CLWSC is similarly bound by the original cost estimates it included in the STM application, and no trending study would have been needed in this case.<sup>132</sup>

Furthermore, Mr. Jensen gave differing reasons for the CIAC entry on the STM, thereby making reliance on the zero value of CIAC of questionable value. He stated that CIAC was not included in the STM because it did not show up on the WSC's balance sheet.<sup>133</sup> He also testified that CLWSC did not include CIAC in the STM because there was not sufficient documentation to support the original cost for the assets.<sup>134</sup> These two reasons appear to conflict with CLWSC's stated position that CIAC was not included on the STM because the Agreement did not provide for the transfer of CIAC from the WSC to CLWSC.

The alleged lack of documentation and the differences between IOUs and water supply corporations do not relieve CLWSC of its responsibility to remove CIAC, and any other sources of cost-free capital, from its rate base.<sup>135</sup> Section 231.31(c)(2)(B)(iv) prohibits customer-CIAC in a utility's original cost or invested capital; it does not allow the inclusion of CIAC if it is too

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<sup>132</sup> In the STM application, CLWSC estimated that the original cost of the WSC's "fixed assets and CIP" was \$26,158,736. CLWSC Ex. 3, p. 1031. In this application, CLWSC has estimated the original cost of both the TWDB-funded assets and the trended assets as \$29,050,912. CLWSC Ex. 66 (\$10,349,699 + \$18,701,213 = \$29,050,912).

<sup>133</sup> The WSC's 2005 balance sheet includes an entry for total net assets of \$10,746,972. CLWSC Ex. 56, p. 101262. However, this amount of total net assets includes \$2,660,012 in donated water systems and \$154,226 in CIAC, as shown on the next page, the WSC's 2005 income statement. CLWSC Ex. 56, p. 101263. Therefore, although the WSC's balance sheet may not have included a separate entry for CIAC, the amount of CIAC was clearly identified on the WSC's income statement.

<sup>134</sup> Tr. p. 1351-1352.

<sup>135</sup> 30 Tex. Admin. Code §§ 291.31(c)(2)(B)(iv) & 291.31(c)(3)(A)(iv) & (v).

difficult to calculate the amount of CIAC or to determine which assets were acquired with CIAC.<sup>136</sup>

Although not tied to specific assets, the evidence shows that from 1994 to 2005, the WSC received large amounts of CIAC: \$10,978,042 in donated equipment and systems; \$723,592 in tap fees; \$672,327 in equity buy-in fees; \$229,205 in capital recovery fees; \$219,470 in member fees; \$629,142 specified as CIAC; and \$327,464 in line extensions.<sup>137</sup> CLWSC's own witness, Dr. Gebhard, in a letter to the WSC's board of directors in 2005 prior to the acquisition, estimated that the WSC had received \$11,097,000 in CIAC from its members and developers.<sup>138</sup> Any difficulty in determining which pre-acquisition assets were acquired through CIAC does not change the evidence that the WSC received developer- and customer- CIAC. The evidence also shows that CLWSC did not attempt to determine which property was attributable to CIAC or to remove CIAC from its rate base.<sup>139</sup> For the reasons stated herein, the ALJs conclude that CLWSC has not shown that its rate base valuation meets the requirements of 30 Tex. Admin. Code § 291.31(c)(2)(B)(iv) and § 291.31(c)(3)(A)(iv).

#### **E. Use of a Negative Acquisition Adjustment to Remove Cost-Free Capital**

Section 291.31(c)(3)(A), title 30 of the Texas Administrative Code requires the exclusion of cost-free capital from other sources from a utility's invested capital, unless there is good cause for its inclusion.<sup>140</sup> The ED asserts that a negative acquisition adjustment is a mechanism to remove cost-free capital from a rate base. The Texas Water Code does not address the use of negative acquisition adjustments, although the TCEQ's rules define acquisition adjustments as:

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<sup>136</sup> Section 291.31(c)(2)(B)(iv) excludes customer-CIAC from both original cost and invested capital and would seem to indicate that the original cost of customer-CIAC is zero, as argued by CEWR. This is inconsistent with CLWSC's position that the original cost of CIAC is included in plant-in-service and then netted out to zero at another point in the rate-base calculation. Tr. pp. 1336-1337.

<sup>137</sup> CEWR Ex. 40, pp. 900224, 900236, 900269, 900302, 900468, 900152, 101359, 900180, 900216, 900325, 900204, 101263 (page references are to CLWSC source document); *see also*, CEWR Closing, p. 25.

<sup>138</sup> CLWSC Ex. 39, p. 630.

<sup>139</sup> Tr. p. 806.

<sup>140</sup> 30 Tex. Admin. Code § 291.31(c)(3)(A)(iv).

- (1) Acquisition adjustment--
  - (A) The difference between:
    - (i) the lesser of the purchase price paid by an acquiring utility or the current depreciated replacement cost of the plant, property, and equipment comparable in size, quantity, and quality to that being acquired, excluding customer contributed property; and
    - (ii) the original cost of the plant, property, and equipment being acquired, excluding customer contributed property, less accumulated depreciation.
  - (B) A positive acquisition adjustment results when subparagraph (A)(i) of this paragraph is greater than subparagraph (A)(ii) of this paragraph.
  - (C) A negative acquisition adjustment results when subparagraph (A)(ii) of this paragraph is greater than subparagraph (A)(i) of this paragraph.<sup>141</sup>

In 30 Tex. Admin. Code § 291.31(d), the TCEQ addresses the “recovery of positive acquisition adjustments.”<sup>142</sup> However, chapter 291 of the TCEQ rules does not address the use of a negative acquisition adjustments, even though the term is defined in the chapter 291 definitions.<sup>143</sup>

There are two “acquisition adjustments” in this proceeding with two different regulatory objectives. First, in its application, CLWSC requested regulatory recognition of its acquisition amounts for accounting purposes. Since this request purportedly does not affect the rates to be determined in this proceeding, the ALJs address this request in a subsequent section of this PFD regarding regulatory approvals. Second, the ED used a negative acquisition adjustment to remove cost-free capital from CLWSC’s rate base. This use of a negative acquisition adjustment would affect CLWSC’s rates, and the ALJs discuss this issue here.

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<sup>141</sup> 30 Tex. Admin. Code § 291.3(1).

<sup>142</sup> 30 Tex. Admin. Code § 291.31(d).

<sup>143</sup> 30 Tex. Admin. Code § 291.1(1)(C).

**1. ED**

The ED recommends that a \$4,014,207 negative acquisition adjustment be included in CLWSC's rate base to remove cost-free capital. The ED recognizes that the TCEQ's rules provide for the inclusion of a positive acquisition adjustment, but do not provide for the use of a negative acquisition adjustment. However, the ED maintains that a negative acquisition adjustment is authorized even though the rules do not specify when a negative acquisition adjustment may be used.

The ED distinguishes between a positive acquisition adjustment and a negative acquisition adjustment. A positive acquisition adjustment is used in limited situations when the purchase price exceeds the original cost of the plant. A positive acquisition adjustment allows a utility to charge more than would be warranted using a typical, original cost estimate when certain regulatory requirements are met. Therefore, according to the ED, it makes sense to have a rule addressing the use of a positive acquisition adjustment to protect a utility's customers.

On the other hand, a specific rule is not needed to authorize the use of a negative acquisition adjustment because the adjustment reduces a utility's rate base, thereby benefitting a utility's customers. The ED asserts that the only showing necessary for a negative acquisition adjustment is that the utility paid less than the value of the assets it obtained. The ED proposes to use a negative acquisition adjustment to remove cost-free capital from the rate base so that CLWSC earns a return only on what it actually invested rather than the estimated value of the assets.

The ED's witness, Ms. Loockerman, relied on the STM to conclude that a negative acquisition adjustment was necessary. The STM provides the following relevant information regarding CLWSC's acquisition of the WSC assets:<sup>144</sup>

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<sup>144</sup> CLWSC Ex. 3, p. 1031.

Item	Amount
Total Purchase Price	\$26,497,000
Total Original Cost	\$37,177,760
Accumulated Depreciation	<\$5,956,303>
Net Book Value	\$31,221,457

The STM also lists the assets that comprise the “total original cost” shown above:<sup>145</sup>

Item	Amount
Cash	\$8,124,695
Restricted and Unrestricted Funds	1,102,550
Accounts Receivable	653,165
Prepayment	45,948
Inventory	245,216
Intangibles	847,450
Fixed Assets and CIP <sup>146</sup>	26,158,736
<b>Total Original Cost</b>	<b>\$37,177,760</b>

To address the cost-free capital reflected by the difference between the purchase price and the total original cost, Ms. Loockerman recommended a negative acquisition adjustment to CLWSC’s rate base in the amount of \$4,014,207. She obtained this amount for the negative acquisition adjustment from CLWSC’s general ledger, provided to her by Mr. Loy.<sup>147</sup>

The ED asserts that a negative acquisition adjustment to remove cost-free capital from a rate base is within the scope of 30 Tex. Admin. Code § 291.31(c)(3)(A)(v). According to the ED, CLWSC will receive a windfall that will be paid by its customers if cost-free capital is not removed from CLWSC’s rate base through the use of the negative acquisition adjustment. The ED maintains that to allow CLWSC to earn a return on the book value of assets it acquired at a

<sup>145</sup> The “total original cost” in the STM includes cash, restricted and unrestricted funds, and accounts receivable. These assets are not included in the parties’ calculations of the original cost component of CLWSC’s rate base. 30 Tex. Admin. Code § 291.31(c)(2)(A) (original cost for rate base purposes includes utility plant, property, and equipment used and useful to the utility in providing service).

<sup>146</sup> “CIP” stands for construction in progress.

<sup>147</sup> ED-DL-1, p. 20; ED-DL-21; Tr. pp. 1031-1035.

lower price would allow CLWSC to earn a return on cost-free capital because the difference between the book value and the purchase price is an investment the utility never made.

The ED argues that his use of a negative acquisition adjustment is consistent with the *Technology Hydraulics, Inc.* decision, a 1994 case decided by the Texas Natural Resource Conservation Commission (TNRCC).<sup>148</sup> In that case, a utility purchased an entire water system for \$10 and the assumption of liabilities.<sup>149</sup> The TNRCC determined that “negative acquisition adjustments are sometimes used to offset the differences between the purchase price and the net book value of utility property used and useful in providing service shown on the seller’s books.”<sup>150</sup> The TNRCC went on to say that “[p]ursuant to Section 13.185(j) of the Texas Water Code, a negative acquisition adjustment cannot be applied to reduce a utility’s depreciation expense on the currently used, depreciable utility property owned by the utility.”<sup>151</sup> However, the ED points out that he is not attempting to use the negative acquisition adjustment to affect CLWSC’s depreciation expense. Instead, the ED is proposing to use the negative acquisition adjustment to reflect the difference between the purchase price and the WSC’s booked values of its assets so that CLWSC’s rate base does not contain cost-free capital. The ED maintains that his use of the negative acquisition adjustment is functionally identical to a finding of fact in *Technology Hydraulics*, which states:

It is appropriate to consider the difference between the Utility’s purchase price and net book value at time of sale in determining return on equity because pre-purchase equity was received at basically no cost and assigning a return on this portion of the Utility’s equity under traditional considerations would result in an excessive and unreasonable allowance for associated risk.<sup>152</sup>

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<sup>148</sup> ED-DL-23, *Application of Technology Hydraulics, Inc.*, TNRCC Docket No. 30089-R, Final Order, Jun. 30, 1994.

<sup>149</sup> Tr. p. 1059.

<sup>150</sup> ED-DL-23, pp. 12-13, *Application of Technology Hydraulics, Inc.*, FOF No. 15.

<sup>151</sup> ED-DL-23, p. 18, *Application of Technology Hydraulics, Inc.*, COL No. 10.

<sup>152</sup> ED-DL-23, p. 14, *Application of Technology Hydraulics, Inc.*, FOF No. 16g.

The ED maintains that the TNRCC's findings and conclusions in *Technology Hydraulics* directly support his position in this case regarding his use of the negative acquisition adjustment.

## 2. CLWSC

CLWSC argues that there is no cost-free capital in its rate base. Mr. Jensen testified that, in addition to the use of the trending study, there is no cost-free capital because CLWSC agreed to the two-year stay-out provision and to the assumption of unliquidated liabilities in bringing the WSC's system into compliance.<sup>153</sup>

CLWSC argues that the ED's use of a negative acquisition adjustment of \$4,014,207 in ratemaking violates the original cost "gold standard" and should not be allowed in the calculation of rate base in this case. CLWSC cites two final orders for the proposition that the use of negative acquisition adjustments are not allowed: *Technology Hydraulics, Inc.* and *Quadvest*.<sup>154</sup> According to CLWSC, the TNRCC in the *Technology Hydraulics* decision "describe[d] the proper way to account for an acquisition in ratemaking if it were allowed, but then disallow[ed] it."<sup>155</sup> CLWSC claims that the *Technology Hydraulics* decision "stands for the proposition that, in the absence of statutory authority, negative acquisition adjustments are not to be included for ratemaking purposes."<sup>156</sup>

## 3. CEWR

It is CEWR's position that no negative acquisition adjustment is necessary if the original cost for the property purchased from the WSC is the price CLWSC paid for the property. If the

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<sup>153</sup> Tr. pp. 1360-1361.

<sup>154</sup> ED-DL-23, *Application of Technology Hydraulics, Inc.*; ED Reply, Att. 2, *Application of Quadvest, Inc.*, SOAH Docket No. 582-03-2832, TCEQ Docket No. 2003-0242-UCR, Final Order Aug. 16, 2004. The *Quadvest* case did not contain a Commission determination regarding negative acquisition adjustments, only an ALJ's denial of a request for a certified question on the issue.

<sup>155</sup> CLWSC Closing, p. 24.

<sup>156</sup> CLWSC Closing, p. 24.

ALJs conclude that the original cost is not the amount paid by the CLWSC for the WSC's assets, then CEWR alternatively argues that the determination of invested capital for that property must account for all donated property and contributions before deciding whether an acquisition adjustment is necessary.

#### **4. OPIC**

On the issue of the ED's use of an acquisition adjustment, OPIC maintains that no adjustment is necessary. OPIC recommends that CLWSC's actual investment in the utility would be protected since the purchase price is CLWSC's original cost of the assets. Since the original cost is the purchase price, there is no need to use an acquisition adjustment.

#### **5. ALJs' Analysis**

In addition to the exclusion of CIAC, 30 Tex. Admin. Code § 291.31(c)(3)(A) requires the exclusion of cost-free capital from other sources from a utility's invested capital, unless there is good cause for its inclusion.<sup>157</sup> The term "cost-free capital" as used in the TCEQ rule is a broad, but undefined, term. Mr. Loy testified that cost-free capital occurs when a utility does not use its own funds to obtain plant assets.<sup>158</sup>

The ALJs disagree with CLWSC's argument that the two-year stay-out provision and the assumption of an open-ended obligation to improve the water system demonstrates there is no cost-free capital in its rate base. The value of these two agreements is unquantifiable. Even if a specific value could be assigned, the value of these two agreements is not as high as CLWSC claims. The two-year stay-out provision is not truly an agreement not to raise rates for two years because CLWSC needed one year of operations to develop an historical test year before it could raise its rates. Therefore, at most, the stay-out provision was only for one year, not two years as CLWSC claims. Further, even though CLWSC assumed an unliquidated obligation to bring the

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<sup>157</sup> 30 Tex. Admin. Code § 291.31(c)(3)(A)(iv).

<sup>158</sup> Tr. p. 476.

WSC water system into compliance, CLWSC will depreciate and earn a return on any investment it makes to its plant. In fact, those very expenditures are included in the rate base in this proceeding, and CLWSC's invested capital valuation of its installed, post-acquisition assets is uncontested.

The valuation of a utility's invested capital is based on the dollar amounts the utility invested in its plant. However, CLWSC has left the ALJs with no way to ascertain the value of its purported investment in the stay-out provision and the assumption of the responsibility to bring the system into compliance. Given that these two considerations cannot be quantified, the ALJs cannot determine where cost-free capital in CLWSC's rate base begins and ends. Therefore, because CLWSC has relied on these two considerations as its justification that there is no cost-free capital in its rate base as required by 30 Tex. Admin. Code § 291.31(c)(3)(A)(v), the ALJs can only conclude that CLWSC has failed to meet its burden of proof that its rate base does not contain cost-free capital.

Although defined in the chapter 291 definitions,<sup>159</sup> the TCEQ's rules do not use the term "negative acquisition adjustment" anywhere in chapter 291, and the ED could not identify another case where a negative acquisition adjustment was used in the manner advocated by the ED here. However, the ED argues that the regulatory authorization for the use of a negative acquisition adjustment is section 291.31(c)(3)(A)(v) of the TCEQ's rules. This section requires the exclusion of cost-free capital from the rate base, thereby providing the regulatory authority to use a negative acquisition adjustment in that manner.

Also, the 1994 TNRCC *Technology Hydraulics* case provides support for the ED's use of the negative acquisition adjustment. The *Technology Hydraulics* decision is not the broad prohibition against the use of a negative acquisition adjustment as advocated by CLWSC. In that case, the TNRCC determined that section 13.185(j) of the Texas Water Code did not provide for the use of a negative acquisition adjustment to reduce the utility's depreciation expense.<sup>160</sup>

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<sup>159</sup> 30 Tex. Admin. Code § 231.3(1).

<sup>160</sup> ED-DL-23, pp. 12-13, *Application of Technology Hydraulics, Inc.*, FOF No. 15.

However, in this case, the ED is not proposing to reduce CLWSC's depreciation expense; he is proposing to use the negative acquisition adjustment to remove cost-free capital from the rate base.

Furthermore, the TNRCC included language in the *Technology Hydraulics* decision that seems to endorse the ED's use of an acquisition adjustment as proposed here. The TNRCC stated that the difference between a utility's purchase price and its net book value can be a proper consideration in determining the return on equity. The language used by the TNRCC in its finding of fact bears repeating:

It is appropriate to consider the difference between the Utility's purchase price and net book value at time of sale in determining return on equity because pre-purchase equity was received at basically no cost and assigning a return on this portion of the Utility's equity under traditional considerations would result in an excessive and unreasonable allowance for associated risk.<sup>161</sup>

This is what the ED intended by his use of the negative acquisition adjustment in this case: take into consideration the difference between the purchase price and net book value in setting the rate base upon which the ratepayers will pay a return.

The ALJs conclude that the *Technology Hydraulics* decision and section 291.31(c)(3)(A)(v) seem to provide a regulatory basis for such an adjustment to a rate base. Also, the ED's negative acquisition adjustment appears to be a reasonable method of removing cost-free capital from CLWSC's rate base in addressing the difference between the purchase price and the net book value. However, the ALJs decline to make such an adjustment to CLWSC's rate base. Although a negative acquisition adjustment appears reasonable in the abstract, the TCEQ's rules are silent on the use of a negative acquisition adjustment, and the ALJs could find no other case that has used the adjustment as the ED's proposes to do here.

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<sup>161</sup> ED-DL-23, p. 14, *Application of Technology Hydraulics, Inc.*, FOF No. 16(g).

**F. Miscellaneous Rate Base Issues**

**1. Customer Deposits**

According to the ED, customer deposits are cost-free capital and must be removed from the rate base. If customer deposits remain in CLWSC's rate base, CLWSC will earn the return established in this proceeding although it will only pay its customers 0.4% in interest.<sup>162</sup> Ms. Loockerman calculated that that \$116,375 in customer deposits should be deducted from CLWSC's rate base.<sup>163</sup>

CLWSC claims that the ED is confusing prepayments with customer deposits. In its rate base, CLWSC added \$4,900 in "prepayments" to its rate base. CLWSC's basis for including these prepayments is 30 Tex. Admin. Code § 291.31(c)(2)(C), which provides that working capital allowance is a component of a utility's rate base, and is composed of "reasonable prepayments for operating expenses (prepayments to affiliated interests) [that] are subject to the standards set forth in [Tex. Water Code] § 13.185(e) . . . ."<sup>164</sup> Mr. Loy testified the most common forms of these prepayments are rent and insurance.<sup>165</sup>

The ALJs disagree with the ED that \$116,375 in customer deposits must be removed from CLWSC's rate base. The ED is mistaken in his assertion that CLWSC proposed to include \$4,900 of "customer deposits" in its rate base. As shown in CLWSC Ex. 66, the utility proposed to include \$4,900 in "prepayments," and prepayments are a component of working capital allowance.<sup>166</sup> The ALJs do not recommend that \$116,375 be deducted from CLWSC rate base as shown on ED-DL-5.

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<sup>162</sup> ED-DL-1, p. 18.

<sup>163</sup> ED-DL-1, p. 18; ED-DL-5.

<sup>164</sup> 30 Tex. Admin. Code § 291.31(c)(2)(C)(ii).

<sup>165</sup> CLWSC Ex. C, p. 11.

<sup>166</sup> CLWSC Ex. 66, p. 2; 30 Tex. Admin. Code § 291.31(c)(2)(C)(ii).

## 2. Accumulated Deferred Federal Income Taxes

The ED also proposed to reduce CLWSC's rate base by deducting ADFIT. The ED argues that, in addition to cost-free capital, 30 Tex. Admin. Code § 291.31(c)(3) requires the exclusion of \$268,037 in ADFIT from rate base. CLWSC counters that the ED's analysis is in error, stating:

Ms. Loockerman made a reduction to CLWSC's rate base for deferred federal income taxes under the theory that they constitute [cost-free] capital to the utility under Tex. Admin. Code § 291.31(c)(3)(A)(v). Ms. Loockerman is in error. Tex. Admin. Code § 291.31(c)(3)(A)(I) [sic] expressly provides that accumulated reserve for the deferred federal income taxes must be excluded from rate base. This separate and distinct rule negates Ms. Loockerman's adjustment.<sup>167</sup>

CLWSC further claims that the ED is using the cost-free capital exclusion as a catch-all to reduce a rate base for items the ED wants to exclude.

ADFIT is the current federal income tax liabilities that are deferred to a future tax year. Because straight-line depreciation is used for ratemaking and accelerated depreciation is used for taxation, many assets can be depreciated faster as an expense for income tax purposes than as an expense for ratemaking purposes. Therefore, actual current tax liabilities are reduced below the amount estimated for ratemaking purposes, and the utility has cost-free use of the difference.<sup>168</sup> When an ADFIT adjustment is made, the utility is denied a return on the amount considered to be customer-supplied capital.

Compared with other rate base issues, there is very little testimony or briefing regarding ADFIT. Contrary to CLWSC's position in its closing arguments, ADFIT is a source of cost-free

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<sup>167</sup> CLWSC Closing, pp. 47-48.

<sup>168</sup> *Cf. AEP Tex. Cent. Co. v. Public Util. Comm'n*, 345 S.W.3d 60, 70 (Tex. 2011). Mr. Loy defined ADFIT as "the difference between what is actually paid to the IRS versus what is reflected in the books or [on] your income statement." Tr. pp. 592-593.

capital.<sup>169</sup> The TCEQ's rules require the exclusion of ADFIT from the rate base, and as CLWSC stated, Ms. Loockerman's adjustment is attempting to do just that. The ALJs agree with the ED that pursuant to 30 Tex. Admin. Code § 291.31(c)(3)(A)(i) and (v), the rate base should be reduced to exclude \$268,037 in ADFIT.

### 3. Unverified Assets

The ALJs also agree with Mr. Adhikari's removal of some of the assets CLWSC claimed in its list of assets. During his inspection 14 months after the test year, Mr. Adhikari could not locate some of the assets shown on CLWSC's asset list. Mr. Adhikari seemed to recall that he discussed this issue with Mr. Hodge and another CLWSC employee at the time of the inspection. However, to the best of his recollection, the CLWSC employees did not dispute that the assets were missing or object when Mr. Adhikari stated that he would remove the missing asset from the asset list.<sup>170</sup> Mr. Adhikari changed the used and useful value of those particular assets to zero.<sup>171</sup>

As a result, Mr. Adhikari deducted \$46,535 from the original cost estimate for those assets not verified.<sup>172</sup> CLWSC claims that this is an unreliable, post-test year adjustment.<sup>173</sup> However, CLWSC did not rebut Mr. Adhikari's deductions for those missing assets by showing that the assets were present during the test year and subsequently retired or moved before Mr. Adhikari's inspection. The only evidence that the specific assets were present during the test year is an entry on an asset list. However, assets that are used and useful in providing water

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<sup>169</sup> Cf. *Office of Pub. Util. Counsel v. Public Util. Comm'n*, 303 S.W.3d 904 912 (Tex. App.—Austin 2010, no pet.) (ADFIT is treated as an offset to invested capital or rate base because it is a cost-free loan from the customers); see also *American Elec. Power Co. v. Public Util. Comm'n*, 123 S.W.3d 33, 38 (Tex. App.—Austin 2003, no pet.) (ADFIT is deducted from the rate base as cost-free funds available for investment).

<sup>170</sup> Tr. pp. 1292-1293.

<sup>171</sup> ED-KA-1, p. 9.

<sup>172</sup> ED-KA-6.

<sup>173</sup> CLWSC Closing, p. 47.

service are not present one year and then gone the next. CLWSC has access to all the records and could easily have addressed this issue, but did not.

The ALJs find Mr. Adhikari's testimony to be credible, and CLWSC did not meet its burden of proof that the missing assets were used and useful during the test year. The ALJs agree with Mr. Adhikari that \$46,535 representing the assets he could not verify should be removed from CLWSC's rate base.<sup>174</sup>

#### 4. Intangibles

As part of his rate base calculations, Mr. Adhikari removed \$237,219 for intangible costs, which included consulting work, system acquisition costs, and "50 years planning."<sup>175</sup> The ED maintains that these intangible assets are not depreciable and do not require replacement. Therefore, these intangible assets, in addition to the \$150,000 cost of the trending study, should be amortized since they are non-recurring costs.<sup>176</sup>

CLWSC argues that the ED has arbitrarily excluded these intangible assets simply because he cannot see or touch the assets. According to CLWSC, intangible water rights and one-eighth of the total annual operating and maintenance expenses are routinely included in a utility's rate base, and the ED's excluded intangible assets are no different.

This issue was decided by the Texas Supreme Court in *State v. Public Util. Comm'n.*<sup>177</sup> In that case, it was argued that the term "property" as used in the original cost definition only referred to physical plant. The supreme court stated that the term property is "commonly used to

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<sup>174</sup> By agreeing with the ED's calculation of rate base and exclusion of unverified assets, the ALJs concurrently reject CEWR's exclusion of plant from CLWSC's rate base on the basis that the plant was not used and useful.

<sup>175</sup> ED-KA-1, p. 12; ED-KA-6.

<sup>176</sup> ED-KA-1, pp. 12-13.

<sup>177</sup> 883 S.W.2d 190 (Tex. 1994).

denote everything which is the subject of ownership, corporeal or incorporeal, *tangible or intangible*, visible or invisible, real or personal.”<sup>178</sup>

Although the supreme court has clarified that property in the original cost context can include intangibles, it is unclear from the record in this case that the items Mr. Adhikari deducted from the CLWSC’s rate base are items of property. The items Mr. Adhikari excluded from rate base are more akin to expenses than to an investment or cost of an asset. Further, these expenses are not analogous to water rights and operations and maintenance expenses as CLWSC suggests. A water right is a property right, clearly an asset that is used and useful in providing water service. Also, the TCEQ’s rules expressly allow up to one-eighth of the total annual operations and maintenance expenses to be included in the rate base as a component of the working capital allowance.<sup>179</sup> The expenses Mr. Adhikari excluded are not similar to water rights or operations and maintenance expenses.

Mr. Adhikari described the intangibles he excluded as “consulting work,” “system acquisition costs,” and “50 years planning.” To the ALJs, it is unclear how CLWSC can have any ownership interest in these types of services or expenses, and it was CLWSC’s burden to show that it is proper to include these types of costs in its rate base. CLWSC has not demonstrated that these costs reflect an investment in CLWSC property that should be included in CLWSC’s rate base. Therefore, for these reasons, the ALJs conclude that the ED’s amortization of the intangible costs was proper as CLWSC has not shown that the excluded expenses should be included in its rate base.

#### **G. Summary of ALJs’ Rate Base Recommendations**

After reviewing the arguments of the parties and the evidence presented, the ALJs conclude that the most reliable estimates of original cost for the pre-acquisition assets with little or no supporting documentation are the booked values. The trending study in this case is not a

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<sup>178</sup> *State v. Public Util. Comm’n*, 883 S.W.2d at 200 (emphasis added).

<sup>179</sup> 30 Tex. Admin. Code § 291.31(c)(2)(C)(iii).

reliable estimate for original cost. Further, CLWSC's reliance on booked costs in its past rate cases demonstrate that the booked values are indeed reliable for ratemaking purposes. In addition, the ALJs conclude that CLWSC did not meet its burden to show that its proposed rate base calculation complied with 30 Tex. Admin. Code § 291.31(c)(2) and (c)(3) because it did not exclude CIAC or cost-free capital from its rate base.

Furthermore, the ALJs recognize that since they have declined to include a negative acquisition adjustment in the rate base, CIAC and cost-free capital is included in CLWSC's invested capital. However, the ALJs conclude that pursuant to 30 Tex. Admin. Code § 291.31(c)(3), there is good cause to include CIAC and cost-free capital in the rate base. As argued by CLWSC, there are no records to correlate the amount of CIAC shown on the WSC's financial statements with specific assets. Further, non-IOUTs use a different accounting system than IOUTs and do not track CIAC in the same manner as an IOUT. Although these reasons do not change the character of property acquired by CIAC, these reasons do provide good cause for the inclusion of this cost-free capital within CLWSC's rate base. The records are simply not available to reliably remove individual, contributed assets from CLWSC's rate base.

The ALJs summarize their recommendations on rate base as follows:

<b>Item</b>	<b>Amount</b>
Original Cost	\$64,206,901
Accumulated Depreciation	<11,248,826>
<b>Net Book Value</b>	<b>\$52,958,075</b>
Working Cash Allowance	625,726
Materials and Supplies	361,235
Prepayments	4,900
ADFIT	<268,037>
Developer CIAC	<14,812,965>
Advances	<772,550>
<b>Rate Base (Total Invested Capital)</b>	<b>\$38,096,384</b>

## V. COST OF SERVICE—EXPENSES

### A. Cost of Service and Allowable Expenses in General

Cost of service is composed of two components: allowable expenses and return on invested capital.<sup>180</sup> Allowable expenses are characterized as expenses which are reasonable and necessary to provide service to the ratepayers, determined by gathering expense information during a historical test year and making adjustments for known and measurable changes.<sup>181</sup> Allowable expenses may include expenses for operations and maintenance, depreciation, and taxes, but may not include expenses for legislative advocacy, political activity, or other unreasonable or unnecessary expenses.<sup>182</sup> CLWSC identified the following categories of operations and maintenance expenses: salaries and wages, contract labor, purchased water, chemicals for treatment, utilities (electricity), repairs/maintenance/supplies, office expenses, accounting and legal fees, insurance, rates case expense, and miscellaneous.<sup>183</sup>

### B. Contested Allowable Expenses

The parties disagreed on whether several operations and maintenance expenses fit the criteria for reasonable and necessary expenses. Specifically, CLWSC contends that:

- An allocation of corporate salaries and related expenses from an affiliate, SJWC, to CLWSC was necessary to capture shared corporate services provided;
- Certain employee benefits were reasonably necessary to offset healthcare costs, attract qualified personnel, and encourage employees to reside in the area;

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<sup>180</sup> 30 Tex. Admin Code § 291.31(a).

<sup>181</sup> 30 Tex. Admin Code § 291.31(b).

<sup>182</sup> 30 Tex. Admin Code § 291.31(b)(1).

<sup>183</sup> CLWSC Ex. 1, p. 18.

- Uncollectible customer accounts should be included in office expenses and adjusted as a known and measurable change due to increased rates; and
- Fees attributable to the CLWSC board of directors were appropriate expenses.

The other parties collectively asserted that the corporate allocations were unrepresentative of costs; certain employee benefits should not be borne by ratepayers; the uncollectible customer accounts were overestimated as a known and measurable expense item; and unexplained fees were paid for the CLWSC board of directors. The ED, however, proposed an alternate allocation method using a service connection ratio in order to fairly apportion corporate expenses. The ED also recommended a significant downward adjustment to SJWC executive salaries and benefits.

## **1. Corporate Allocations and Related Expenses**

### **a. Overview**

Once monthly, administrative and general expenses were transferred from SJWC<sup>184</sup> to CLWSC for corporate overhead expenses, referred to as a “corporate service fee.”<sup>185</sup> According to Mr. Jensen, there are three categories of expenses and three methods to calculate the annualized expense allocations:<sup>186</sup>

- Salaries and associated labor costs, such as payroll taxes, employee benefits, and travel and entertainment expenses, are recorded and allocated using a one-month-per-year representative time study;
- Property-related expenses for the corporate headquarters in San Jose, California, including maintenance, janitorial, landscaping, property taxes,

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<sup>184</sup> SJWC is the affiliate that provides water service to San Jose, California.

<sup>185</sup> CLWSC Ex. 1, p. 12. These expenses were transferred through SJW Corp.

<sup>186</sup> CLWSC Ex. 1, pp.13-14.

building depreciation and utilities, are allocated based on a square footage of the office; and

- Corporate and accounting services, such as auditing and Sarbanes-Oxley (SOX) fees, costs of being publicly traded, computer equipment, and the accounting system are allocated by proportion of revenue among each of the affiliates.

As enumerated in the application, CLWSC's annual total of the allocated corporate costs for the test year was \$578,090: \$514,191 for salary expenses allocated by the time study; \$27,918 for property-related expenses allocated by square footage; and \$35,981 for corporate expenses allocated by revenue.<sup>187</sup>

**b. Applicable Law**

Section 13.002(2) of the Texas Water Code defines "affiliated interest" or "affiliate" as:

- (A) any person or corporation owning or holding directly or indirectly five percent or more of the voting securities of a utility;
- (B) any person or corporation in any chain of successive ownership of five percent or more of the voting securities of a utility; [or]
- (C) any corporation five percent or more of the voting securities of which is owned or controlled directly or indirectly by a utility . . . .

Payment to affiliated interests for costs of any services, or any property, right or thing, or for interest expense may not be allowed either as a capital cost or as an expense except to the extent that the regulatory authority finds that payment to be reasonable and necessary. A finding of reasonableness and necessity must include specific statements setting forth the cost to the affiliate of each item or class of items in question and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations.<sup>188</sup> Further, if a utility fails to

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<sup>187</sup> CLWSC Ex. 43, p. 1404.

<sup>188</sup> Tex. Water Code § 13.185(e).

provide, within a reasonable time after the application is filed, the necessary documentation or other evidence that supports the costs and expenses that are shown in the application, the Commission may disallow the unsupported costs or expenses.<sup>189</sup>

**c. CLWSC**

Mr. Jensen testified that a corporate allocation was necessary because efficiencies result from shared costs and expertise in areas such as engineering and technology, legal services, accounting and financial services, regulatory activities, and support services.<sup>190</sup> Mr. Jensen supported apportioning the salary expenses by a time study of SJWC employees and executives and their proportional time spent on the four affiliates: SJWC, CLWSC, SJW Corp., and SJW Land Company. As recounted by Mr. Jensen, SJWC has 352 employees, CLWSC has 35 employees, and SJW Land Company and SJW Corp. have no employees.

He explained that an annual representative time study was conducted in March of each year, with SJWC executives and employees tasked with recording time spent working on each affiliate.<sup>191</sup> Then, based on the percentage of time recorded, each affiliate was allocated their proportion of the annual salary and benefit expenses of each employee who worked on their business, ranging from an allocated percentage of the SJWC president's salary and benefits of \$1,377,238 to an allocated percentage of a staff accountant's salary and benefits of \$63,000.<sup>192</sup> Employee benefits were also apportioned using the time study ratio and included bonuses ranging from \$6,500 to \$156,250, as well as stock options ranging from \$5,736 to \$595,988.<sup>193</sup> The average percentage of time recorded as spent on CLWSC business by the employees during

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<sup>189</sup> 30 Tex. Admin. Code § 291.28(4).

<sup>190</sup> CLWSC Ex. A, pp. 12-13.

<sup>191</sup> Tr. p. 98.

<sup>192</sup> CLWSC Ex. 43, p. 1407.

<sup>193</sup> Tr. pp. 98-101.

the time study period was 8%.<sup>194</sup> In the application, CLWSC was allocated \$504,158 in total salary expenses based on the time study.<sup>195</sup>

Travel and entertainment expenses were similarly apportioned: each employee's expenses were allotted in proportion to the March 2010 time study based on the employee's travel time and the expenses spent on each affiliate.<sup>196</sup> For instance, Mr. Jensen accrued \$41,454 total travel and entertainment expenses in 2009, and according to the time study, spent 5% of his time on CLWSC business, for a total of \$2,073 in apportioned travel and entertainment expenses.<sup>197</sup> Altogether, there were six executives whose total travel and entertainment expenses ranged from \$2,220 to \$76,387, for a total of \$137,948 in travel expenses.<sup>198</sup> Based on the time study, the allocation to CLWSC for travel and entertainment expenses totaled \$10,003.

For property-related expenses such as janitorial services, landscaping, building maintenance, and property taxes for corporate headquarters located in San Jose, California, the allocation was based on square footage. For example, out of the total amount for yearly janitorial service and landscaping in San Jose, CLWSC was allocated \$3,524.<sup>199</sup> The exact square footage of each affiliate, however, was not provided.<sup>200</sup> In the application, CLWSC was allocated \$27,918 in total property-related expenses for the San Jose headquarters.

For corporate and accounting expenses, an allocation was based on revenue using a ratio of CLWSC revenue, or \$7,845,134, to total SJWC and CLWSC revenue, or \$223,941,760,<sup>201</sup> for a proportion factor of 3.6%. In the application, CLWSC was allocated \$35,981 in corporate and

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<sup>194</sup> CLWSC Ex. 43, p. 1407.

<sup>195</sup> CLWSC Ex. 43, p. 1404. \$514,191 less travel and entertainment expenses of \$10,003.

<sup>196</sup> The expenses were not broken down by category of travel or entertainment.

<sup>197</sup> CLWSC Ex. 43, p. 1405.

<sup>198</sup> CLWSC Ex. 43, p. 1405. A seventh executive record no expenses.

<sup>199</sup> CLWSC Ex. 43, p. 1404.

<sup>200</sup> CLWSC Ex. 43, p. 1406.

<sup>201</sup> CLWSC Ex. 43, p. 1406; ED-DL-6.

accounting expenses, which included auditing and SOX fees of \$25,776, costs of public trading of \$8,713, computer equipment costs of \$759, and an accounting system cost of \$733.<sup>202</sup>

CLWSC opposes the ED's connection-based allocation approach as an unfair method to apportion corporate expenses. CLWSC argues that its representative time study method has been approved by the California Public Utility Commission as fair and reasonable. Further, its allocation method is equitable because only two affiliates, SJWC and CLWSC, have connections, but all the affiliates share the expenses. CLWSC also maintains that the ED's proposed reduction of executive salaries is arbitrary and capricious. As to the ED's position that many expenses are shareholder expenses, CLWSC asserts that it receives the benefit of being publicly traded, such as access to capital at a reasonable rate. However, because the company is frequently audited, there is a trade-off in higher accounting costs.

**d. ED**

Ms. Loockerman testified that there were flaws in CLWSC's time study: (1) CLWSC did not provide details of the time study, such as the type of work done; (2) CLWSC may have overstated the time spent on certain activities depending on whether the study was conducted in a rate or non-rate application year; and (3) one month is not representative of the work done in an entire year or longer. Further, CLWSC included shareholder expenses that should not be borne by CLWSC ratepayers, according to the ED. For instance, SJWC's Director of Corporate Development was responsible for acquisitions and corporate development, rather than utility operations; yet, his salary was apportioned to CLWSC.

The time study offered too many fluctuations and too few supporting documents, according to Ms. Loockerman. She noted that the salaries allocated by time increased by 74.6% from 2008 to 2009, but only increased by 3.4% from 2009 to 2010.<sup>203</sup> This unexplained variation supported her assertion that a time study based on one month does not represent a valid

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<sup>202</sup> CLWSC Ex. 43, p. 1404.

<sup>203</sup> ED-DL-1, p. 9.

annual measure. She also observed that CLWSC did not provide a comparison to previous time studies or an analysis of whether a project was routine or unusual.

The ED agreed that a corporate allocation to CLWSC was reasonable and necessary, but proposed an alternate allocation method using a service-connection ratio to fairly apportion corporate expenses. He also recommended a significant downward adjustment to SJWC's executive salaries and benefits. Applying the ED's connection-ratio formula, in combination with a reduction in executive salary, bonuses, and stock options, resulted in an ED-recommended corporate allocation reduction of \$206,828.<sup>204</sup>

First, an adjustment to "excessive" allocated corporate salaries was necessary, according to Ms. Loockerman.<sup>205</sup> She reasoned that the base salary of the SJWC president of \$650,000 should be limited to \$400,000, which is no higher than the U.S. President's salary. Then, she reduced other executive salaries above \$200,000 by 36%, representing the same proportional reduction from \$650,000 to \$400,000.<sup>206</sup> Further, she recommended that all bonuses be reduced by two-thirds because bonuses are earned relative to stockholder investment returns and all stock options should be eliminated because the options are tied to profitability for stockholders.<sup>207</sup>

Next, Ms. Loockerman recommended using the number of connections to allocate expenses. In order to fairly apportion corporate expenses, she used a service connection ratio of CLWSC connections, or 9,068 connections, to total SJWC and CLWSC combined connections, or  $9,068 + 235,000 = 244,068$  connections. That results in a 3.7108% connection ratio for CLWSC.<sup>208</sup> The other affiliates, SJW Corp. and SJW Land, do not have any connections.

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<sup>204</sup> ED-DL-1, p. 12.

<sup>205</sup> ED-DL-6, p. 1.

<sup>206</sup> ED-DL-1, p. 11; Tr. pp. 1153-1155.

<sup>207</sup> ED-DL-1, p. 11.

<sup>208</sup> ED-DL-6, p. 1.

Regarding travel and entertainment expenses, the ED argues that CLWSC ratepayers should not have to pay these expenses because SJWC chose to maintain offices out of Texas. Ms. Loockerman also recommended a two-thirds reduction in salaries exceeding \$200,000 and then an allocation based on the number of connections.<sup>209</sup> The following table summarizes the ED's recommendation:

**Allocation Based On Number of Connections<sup>210</sup>**

<b>Category</b>	<b>CLWSC Requested</b>	<b>ED's Recommendation</b>
Administrative & General Salaries	\$328,249	\$195,552
Employee Benefits, etc.	175,909	104,797
Travel and Entertainment	10,033	3,467
<b>Total</b>	<b>\$514,191</b>	<b>\$303,816</b>

**e. CEWR**

CEWR advocates disallowing all corporate allocations. CEWR points out that the burden of proof is on CLWSC to show that the expenses are reasonable and necessary and that the costs allocated to CLWSC are no higher than the price paid by its other affiliates for the same items. Because CLWSC never produced the time sheets or underlying documentation to support the time studies, CEWR argues that there was no method to determine if the time spent by various SJWC executives was properly assigned to CLWSC.<sup>211</sup> For instance, Ms. Heddin noted that CLWSC has allocated 9% of the SJWC President's time even though CLWSC has a general manager in Texas to oversee its operations.<sup>212</sup> Also, without the supporting documentation, no determination can be made as to whether the cost of service was no higher than the costs

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<sup>209</sup> ED-DL-6, p. 1.

<sup>210</sup> ED-DL-6, p. 1.

<sup>211</sup> ED-DL-1, p. 7.

<sup>212</sup> CEWR Ex. 1, p. 37.

allocated to the other affiliates. The amount allocated to the other three affiliates was not provided.

CEWR further argues that while the method proposed by the ED to reduce high salaries and bonuses and disregard the time studies is defensible, the ED's proposal to substitute an allocation based on connections is an attempt to fix what should be CLWSC's responsibility. CLWSC had to demonstrate that its expenses were reasonable and correctly allocated. Because it failed to do so, CEWR contends that all allocated expenses should be disallowed.

**f. OPIC**

OPIC agrees with CEWR that \$578,076 should be disallowed because CLWSC failed to meet its burden to show the allocations were reasonable and necessary.

**g. ALJs' Analysis**

Based on the evidence and argument, the ALJs conclude that: (1) some corporate costs for executive salaries and travel and entertainment for those employees who recorded time spent on CLWSC operations are reasonable and necessary, but all bonuses and stock options should be disallowed; (2) the costs for property-related expenses are not reasonable and necessary and should be disallowed; and (3) some costs of corporate and accounting services are reasonable and necessary, but the costs of publicly trading stock should be disallowed. The ALJs also conclude that the ED's method of apportioning salary-related and travel and entertainment expenses based on connections, rather than on a time study, meets the statutory and regulatory criteria of ensuring that costs to each affiliate are calculable relative to all affiliates and that the prices charged are no higher than those costs charged to other affiliates by the supplying affiliate.

In accordance with these determinations, the reasonable and necessary allocable corporate costs total \$172,715.55, including \$139,789.55 for general salaries; \$5,118 for travel

and entertainment; and \$27,808 for corporate and accounting services. Thus, \$405,913 should be disallowed. The calculations are as follows:

- The total base general salary, less bonuses and stock options, for employees who recorded time spent on CLWSC operations was \$3,767,100.<sup>213</sup> When multiplied by the 3.7108%<sup>214</sup> connection ratio, a reasonable and necessary allocable expense for salaries is \$139,789.55, and \$364,368.45 of the \$504,158<sup>215</sup> allocated to CLWSC should be disallowed;
- The total travel and entertainment expense for employees who recorded time spent on CLWSC operations was \$137,948.<sup>216</sup> When multiplied by the 3.7108%<sup>217</sup> connection ratio, a reasonable and necessary allocable expense for travel and entertainment is \$5,118, with \$4,914 disallowed of the \$10,033 in allocated travel and entertainment expenses;
- The property costs for maintenance and upkeep of the SJWC corporate headquarters are not allocable because the allocation does not comport with statutory criteria and the expenses were not relatable to utility services provided to CLWSC ratepayers, and thus, \$27,918 is disallowed; and
- A portion of the \$35,981 for corporate expenses allocated by revenue is reasonable and necessary. The costs of SJW Corp. being publicly traded, \$8,713, should be disallowed, and a total corporate expense of \$27,808 should be allowed.

The ALJs conclude that the ED's approach of using the number of connections in proportion to expenses provides a rational method to apportion expenses among affiliates and meets the statutory requirements related to affiliate transactions. In particular, section 13.185(e) of the Texas Water Code provides that payment to affiliated interests for reasonable and necessary costs of any services must include (1) a specific statement setting forth the cost to the affiliate of each item in question and (2) a finding that the price to the utility is not higher than prices charged by the supplying affiliate to other affiliates for the same item.

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<sup>213</sup> CLWSC Ex. 43, p. 1407.

<sup>214</sup> ED-DL-6, p. 1.

<sup>215</sup> \$514,191 less travel and entertainment expenses of \$10,003.

<sup>216</sup> CLWSC Ex 43, p. 1405.

<sup>217</sup> ED-DL-6, p. 1.

By apportioning the corporate costs for executive salaries and travel and entertainment for those employees who recorded time spent on CLWSC operations between just the two affiliates with connections, the ED's method provides a simple method to set forth the cost to each affiliate. Also, it provides an objective and easily-determinable process to ensure that no affiliate is paying any higher price for any service provided. For instance, based on the connections ratio, of the SJWC president's base executive salary of \$625,000, \$23,192.50 is paid by CLWSC while the remainder of \$601,807.50 is paid by SJWC. This is a fair and reasonable apportionment because the connections serviced by CLWSC are approximately 3.7% of the total service connections, while SJWC services the remaining 96.3%.

As to CLWSC's assertion that a connection-based method does not apportion the expenses fairly among affiliates without connections, the ALJs agree with the ED that these expenses were apportioned based on other criteria. Ms. Loockerman pointed out that there were many executives who did not perform any work at all for CLWSC and were not included in CLWSC's allocation as a result of the time study. For example, the senior vice-president (\$300,000 salary), director of real estate (\$145,000 salary), and human resources specialist (\$69,000 salary) reported that none of their time was spent on CLWSC matters. These are salary expenses that are properly allotted to other affiliates.

The ED, however, had originally attempted to limit executive salaries by applying a formula based on the U.S. President's salary. This presents a speculative assessment of what is a reasonable executive salary. Instead, the base salaries should be apportioned without the bonuses and stock options, which are tied to stock-related performance. The criteria for a bonus, for instance, as detailed on the "2011 performance goals" lists a target goal of a 10.20% return on equity for SJW Corp. in order to entitle the recipient to earn \$104,170 in bonuses. Stock options are similarly related to the price of the stock and the prosperity of the publicly-traded corporation, rather than to providing utility services to ratepayers.

Further, the ALJs find that the CLWSC ratepayers should not pay for property-related expenses in San Jose because these allocations do not conform with the statutory criteria that the

costs of these property-related expenses must include a specific statement setting forth the cost to the affiliate of each item in question and a finding that the price to the utility is not higher than prices charged to other affiliates for the same item. These allocations were made by square footage, but the percentage allocated to each affiliate was not provided; the buildings or land considered in the equation was not furnished; and there was no criteria for expenses allocated. As such, there is no way to ascertain whether the statutory criteria were met or whether the expenses were reasonable and necessary to provide water utility services. Accordingly, CLWSC has failed to meet its burden of proof, and these expenses should not be borne by CLWSC ratepayers.

As to the \$35,981 in corporate and accounting expenses that were allocated to CLWSC by revenue, the ALJs conclude that the use of the revenue of two affiliates in proportion to expenses provides a rational method to apportion corporate expenses and meets the statutory requirements related to affiliate transactions. Specifically, the ALJs find that the method of using a ratio of CLWSC revenue, or \$7,845,134, to total SJW Corp. and CLWSC revenue, or \$223,941,760, for a proportion factor of 3.6%, amounts to roughly the same percentage as a connection-based method of 3.7108%. This percentage represents a fair and reasonable proportion of expenses based on the size and operations of the two affiliates, in relation to the auditing, accounting, and computer-related services provided.

Apportioning the corporate and accounting costs between just the two affiliates based on revenue provides a straightforward approach to set forth the cost to each utility affiliate. Also, it provides an objective and easily-determinable process to ensure that no affiliate is paying any higher price for any service provided. Thus, this is a fair and reasonable apportionment because CLWSC's percentage of corporate costs is allocated at 3.6%, while SJWC is allocated the remaining 96.4% of total costs. For instance, of the total accounting and SOX fees of \$710,000, CLWSC was allocated \$25,776, while SJWC is allocated the remaining costs; of the total computer equipment and related software total of \$20,899, CLWSC was allocated \$759 while SJWC is allocated the remaining costs; and of the total accounting system software of \$20,200, CLWSC was allocated \$733, while SJWC is allocated the remaining costs. The ALJs, however,

agree with the ED that it is not appropriate to allocate the costs of being publicly traded, or \$8,713 in costs. This amount is more appropriately borne by the stockholders rather than the CLWSC ratepayers. However, the remaining expenses are reasonably related to providing utility services. Accordingly, a portion of the \$35,981 for corporate and accounting expenses allocated by revenue is reasonable and necessary, once \$8,713 is disallowed, for a total allowable expense of \$27,808.

## **2. CLWSC Employee Benefits**

### **a. Parties' Position**

CLWSC has included the following expenses for the thirty-five local employees of CLWSC: dental insurance for employees; medical insurance for employees and dependents; contributions to a Health Saving Account (HSA); and waiver of the base fee for a water meter (base water fee). According to Mr. Hodge, CLWSC's general manager, the medical benefits are necessary to attract and retain employees, to encourage employees to live nearby, and to compensate employees for the health insurance deductible of \$2,500 by an HSA plan.<sup>218</sup>

CEWR contends that these expenses are not reasonably necessary to provide water utility services. According to Ms. Heddin, the medical and dental expenses include \$225 in monthly premiums for thirty-one employees, or \$83,700 annually, and \$1,250 annually for thirty-one HSA contributions, or \$38,750 total annually, for a grand total of \$122,450. Thus, out of the \$272,291 in total local CLWSC employee benefits, CEWR argues that \$122,450 should be disallowed, leaving \$149,841 in allowable expenses.<sup>219</sup> The amount of the HSA employer contribution, however, differed, according to Ms. Loockerman, who testified that it totaled \$63,750.<sup>220</sup>

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<sup>218</sup> Tr. p. 1437.

<sup>219</sup> CEWR Ex. 1, p. 36.

<sup>220</sup> ED-DL-1, p. 15.

As to the base water fee, CLWSC pays its employees' \$40 monthly fee, or \$17,626 total annually, if an employee lives in the service area.<sup>221</sup> This improves service, according to Mr. Hodge, because employees are "on call" and do not have to travel far if a water main breaks, for instance.<sup>222</sup> Only employees who live in the service area are eligible for the base water fee. CEWR, however, contends that CLWSC's employees are well-compensated with generous salaries and benefits such as paid time off, deferred compensation plans, overtime meals and pay, employee education, etc. and that this free meter expense should not be included as a cost of service.

Unlike CEWR, the ED maintains that although the HSA and base water fee expenses should be removed, the medical and dental expenses should be allowable. The ED contends that the \$63,750 HSA expense goes beyond providing customary health and dental insurance. Further, the base meter fee payment is not necessary because the salaries and benefits are already generous without this additional benefit. The \$17,626 base meter fee was included in miscellaneous expenses and should be removed, according to the ED.<sup>223</sup>

**b. ALJs' Analysis**

The ALJs agree with CEWR and the ED that the HSA and base water expenses should be removed. The ALJs, however, concur with CLWSC that the medical and dental expenses are allowable expenses. Accordingly, the ALJs accept the ED's calculation of costs and recommend that both the \$63,750 HSA expense and the \$17,626 base water fee expense should be removed from the insurance and miscellaneous columns respectively.

In the ALJs' opinion, providing health and dental for employees and dependents presents sufficient incentive to attract and retain employees. There is no basis to provide additional incentives above what are typically provided to employees, as substantiated by Ms. Loockerman.

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<sup>221</sup> ED-DL-1, p. 15.

<sup>222</sup> CEWR Ex. 1, p. 36.

<sup>223</sup> ED-DL-1, p. 15.

Further, there were no comparisons provided by CLWSC to show that a utility of its size would be expected to provide an HSA or base water fee.

### **3. Bad Debt/Uncollectible Accounts Expenses**

CEWR argues that the category “office expense” included \$116,739 for “uncollectible accounts,” which should be excluded from allowable expenses. CEWR points out that the test year amount of \$69,003 was adjusted to \$116,739 for known and measurable changes, based on an anticipated increase in rates and the resultant impact on the ability to collect. Ms. Heddin testified that bad debt should not be classified as an expense, but rather as a risk to shareholders.<sup>224</sup> Mr. Loy confirmed that the bad debt rate is impacted by an adjustment to price.<sup>225</sup>

The ALJs conclude that the test year amount of \$69,003 is the correct amount that should be included in allowable expenses. The significant increase of \$47,736 over the test year amount anticipated by CLWSC is speculative. There was no testimony offered to justify such a significant increase in anticipated bad debt and therefore, expenses should be adjusted to the test year amount of \$69,003.

### **4. Directors’ Fees**

CEWR and the ED objected to the inclusion of fees paid to the CLWSC board of directors in the amount of \$53,205. Ms. Loockerman explained that the expense should be disallowed because the services provided by the directors are for the benefit of the shareholders and CLWSC already has a general manager and full staff to operate its business.<sup>226</sup> Further, Ms. Loockerman testified that she was aware of no other IOU that paid board members for their

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<sup>224</sup> CEWR Ex. 1, p. 36.

<sup>225</sup> CLWSC Ex. C, p. 55.

<sup>226</sup> ED-DL-1 Supp., p. 2.

services. CEWR also argued that SJW Corp. has a board of directors which is duplicative of the services rendered by the CLWSC board of directors.

The ALJs agree with CEWR and the ED that this payment should be disallowed as an expense. No explanation was offered to justify the \$53,205 expense for the board. Because CLWSC failed to show that the expense was reasonable and necessary, and in light of the evidence that the provided services are duplicative, related to shareholder business only, and not customary, the ALJs conclude that the expense should be disallowed.

## **5. Rate Case Expenses**

Rate case expenses of \$57,250 were included in operations and maintenance expenses.<sup>227</sup> The ALJs determine that these expenses should be removed from this section and considered in tandem with the rate case expense discussion in Section XI of this PFD. The rate case expenses should then be recovered by a specific monthly surcharge, if CLWSC qualifies to recover its rate case expenses.

## **6. Normalized Expense Adjustments**

### **a. Parties' Position**

Mr. Loy testified that he “normalized” CLWSC’s test year sales volume to adjust for the dry summer months that occurred during the test year.<sup>228</sup> He explained that drought conditions resulted in increased water consumption, which then impacted CLWSC’s overall revenue and expenses for chemicals, purchased water, utilities, and office expenses.<sup>229</sup> According to

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<sup>227</sup> ED-DL-5 Supp., p. 2.

<sup>228</sup> CLWSC Ex. C, pp. 3 & 32.

<sup>229</sup> Tr. p. 536.

Mr. Loy, if rates are calculated using the drought volumes and increased expenses, then CLWSC would not have a reasonable opportunity to recover its allowed return.<sup>230</sup>

Mr. Loy testified that normalizing is an attempt to level off the billing so in a dry year or wet year over-collection or under-collection of rates does not occur.<sup>231</sup> The goal is to reflect what is most likely to occur during the prospective period when rates will be in effect. He also noted that in the application, CLWSC proposed tiered gallonage rates with the price increasing per gallon as consumption increases.<sup>232</sup>

To normalize revenue and expenses, Mr. Loy used the two atypical years: 2008, an unusually wet year, and 2010, a drought year.<sup>233</sup> Because CLWSC only had the billing records for the prior four years, he stated that he was not able to use a five- or ten- year average, as he would have preferred.<sup>234</sup> Viewing the records, he found the following:<sup>235</sup>

- In 2008, the average usage for June through September was 7,120 gallons per month per household;
- In 2010, the average usage for the same time period was 10,900 gallons per month per household;
- In 2008, the non-summer average was 5,950 gallons per month per household; and
- In 2010, the non-summer average was 5,460 gallons per household in the same time period.

Mr. Loy then took the summer and non-summer averages for each year and multiplied it by the actual test year bill count for each year to arrive at a normalized water usage. The result was a normalized average of 6,800 gallons per household per month, rather than the test-year

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<sup>230</sup> CLWSC Ex. C, p. 32.

<sup>231</sup> Tr. pp. 528-529.

<sup>232</sup> ED-KA-1, pp. 25-26.

<sup>233</sup> CLWSC Ex. 1, p. 115; CLWSC Ex. C, p. 33.

<sup>234</sup> CLWSC Ex. C, p. 33.

<sup>235</sup> CLWSC Ex. 1, p. 115.

average of 7,270 gallons, that reduced the test-year, system-wide billed consumption by 48,314 thousand gallons.<sup>236</sup>

Mr. Loy also adjusted expense amounts to comport with the normalized consumption results. Comparing the average rainfall amounts with the ten years of data from New Braunfels, Texas, produced similar results, according to Mr. Loy.<sup>237</sup>

The ED disputes that the normalization proposed by CLWSC is reliable. Ms. Loockerman testified that data gathered from two years was not a representative number of years to justify normalization.<sup>238</sup> Further, she pointed out that extreme weather adjustments have been used in other jurisdictions, but not in Texas by the TCEQ.<sup>239</sup>

Mr. Adhikari agreed that two years of data is not enough information to calculate normalized volumetric rates.<sup>240</sup> He pointed out that CLWSC used a dry and wet year for the calculation, yet there was another very dry year in 2011. He recommended using at least five years of data to support calculations, rather than two years. Otherwise, he felt that the most accurate measure was using the actual test year numbers of gallons pumped, purchased, and billed in calculating the gallonage rate, rather than a normalized amount.<sup>241</sup> Accordingly, the ED recommends that the following expenses be adjusted to remove CLWSC's normalization of the amount: reduce the purchased water expense by \$53,370; reduce the chemical and treatment expense by \$3,732; reduce the utility expense by \$22,517; and reduce the office expense by \$1,070.<sup>242</sup>

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<sup>236</sup> CLWSC Ex. C, p. 33.

<sup>237</sup> CLWSC Ex. C, p. 35.

<sup>238</sup> Tr. p. 1174.

<sup>239</sup> Tr. pp. 1174-1175.

<sup>240</sup> ED-KA-1, p. 28.

<sup>241</sup> Tr. p. 1174.

<sup>242</sup> ED-DL-1 Supp., pp. 6 & 12.

CEWR argues that using the test year volumes is required, unless CLWSC can demonstrate that the test year volumes substantially deviated from normal. Here, using only two years of volumetric consumption data to set rates would not produce an accurate calculation. CEWR also points out that in the last rate case filed by CLWSC, which used test year data from a wet year, CLWSC did not use normalized rates.

**b. ALJs' Analysis**

Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses, based on the utility's historical test year expenses, adjusted for known and measurable changes.<sup>243</sup> Therefore, the issue presented is whether the volumetric consumption data gathered from averaging two years to arrive at a normalized water usage is sufficient to adjust actual expenses based on a known and measurable change. The ALJs conclude that the proposed adjustment based on two years of weather data is not known and measurable.

Mr. Loy testified that using ten-year averages would be the optimal way to normalize volumes. The ALJs agree with this premise. Using a ten-year average would, most likely, mitigate the various extreme weather cycles and provide a more reasonable snapshot of what is "normal" in order to allow known and measurable adjustments to actual expenses. For instance, averaging an extreme drought year, where over 10,000 gallons per summer month were used, with an average wet year, where over 5,000 gallons were used, may skew the average and produce a higher than normal usage average. This average would then be used to estimate higher expenses and collect rates based on estimates for higher usage that may not actually materialize. Instead, using ten or more years of data moderates the weather extremes and produces a more accurate estimate of weather patterns and their effects on water usage.

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<sup>243</sup> 30 Tex. Admin. Code § 291.31(b).

Substituting an estimate of expenses based on limited and speculative data does not constitute a known and measurable adjustment to actual expenses during its historical test year. Accordingly, the ALJs recommend that the normalized volumetric expense adjustments for the following expenses should be removed: the purchased water expense should be reduced by \$53,370, the chemical and treatment expense should be reduced by \$3,732, the utility expense should be reduced \$22,517, and the office expense should be reduced by \$1,070.

**7. Summary of ALJs' Expense Recommendations**

To summarize, the ALJs recommend a total operations and maintenance expense disallowance of \$645,580.45. This includes the following specific disallowances:

<b>Expense</b>	<b>Amount</b>
Corporate Allocations and Related Expenses	\$405,913.45
HSA	63,750
Base Water Fee	17,626
Bad Debt/Uncollectible Accounts	47,736
Directors' Fees	53,305
Rate Case Expense	57,250
<b>Total</b>	<b>\$645,580.45</b>

In accordance with the ED's specific recommendations as modified in this PFD, the ALJs recommend the following operational and maintenance expenses be approved as reasonable and necessary to provide service to the ratepayers:<sup>244</sup>

<b>Category</b>	<b>ALJs' Recommendations</b>
Salaries	\$1,084,930.55 <sup>245</sup>
Contract Services	289,988
Purchased Water	1,141,619
Chemicals and Treatment	91,100
Utilities	459,763
Repairs and Maintenance	996,704

<sup>244</sup> ED-DL-5 Supp., p. 2.

<sup>245</sup> \$1,490,844 - \$405,913.45 (ALJs' adjustment) = \$1,084,930.55.

<b>Category</b>	<b>ALJs' Recommendations</b>
Office Expense	332,128
Accounting and Legal	84,359
Insurance	311,422
Rate Case Expense	0
Miscellaneous	213,798
<b>Total</b>	<b>\$5,005,811.55</b>

**C. Depreciation Expense**

Consistent with the ALJs' recommendations in Section IV of this PFD, the ALJs propose that the annual depreciation expense calculated by the ED, or \$1,897,872, is the appropriate depreciation expense amount.<sup>246</sup>

**D. Federal Income Taxes**

The ALJs have made recommendations in this PFD that would, if adopted, change the rate base, the capital structure, and the rate of return.<sup>247</sup> These recommendations would change the amount of CLWSC's return and the amount of the federal income tax expense. Therefore, the ALJs request that the ED recalculate the federal income tax expense using the recommended adjustments in this PFD and include that in his exceptions to the PFD.

**E. Taxes Other Than Federal Income Taxes**

For payroll taxes, CLWSC listed the test-year taxes as \$134,817, with a known and measurable change of \$8,483 for a total of \$143,300. CLWSC requested that 50% of the payroll taxes, or \$71,650, be classified as a fixed expense, and the remaining 50% be classified as a variable expense. For property and other taxes, CLWSC reported the test-year tax as \$91,320, with a known and measurable adjustment of \$12,939, for a total of \$104,259.<sup>248</sup> CLWSC

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<sup>246</sup> ED-KA-6.

<sup>247</sup> The ALJs discuss the issues of capital structure and rate of return in subsequent sections of the PFD.

<sup>248</sup> CLWSC Ex. 1, p. 20.

requested that 100% of the property taxes be classified as a fixed expense. These figures were later revised to \$172,389 for property taxes and \$141,858 for payroll taxes.<sup>249</sup>

The ED, however, adjusted the property and franchise taxes and non-revenue related taxes to reflect flow through changes.<sup>250</sup> The ALJs agree with the ED and find the following are reasonable and necessary expenses for taxes other than federal income taxes:

Category	ALJs' Recommendation
Property and Franchise Taxes Payroll Taxes	\$142,179
Other Miscellaneous Taxes	141,858
<b>Total Other Taxes</b>	<b>\$284,037</b>

## VI. COST OF SERVICE—RATE OF RETURN

### A. Rate of Return in General

The rate of return is expressed as a percentage of invested capital.<sup>251</sup> It allows a utility an opportunity to earn a return on its used and useful invested capital, over and above its reasonable and necessary operating expenses of providing service, and preserve the financial integrity of the utility.<sup>252</sup> It also permits a utility to meet its credit obligations and reasonably compete in the financial markets for future capital, namely, a return on equity.<sup>253</sup> The primary task of setting a rate of return is to determine the cost of capital.

The cost of capital is the composite of the cost of the various classes of capital used by the utility: (1) debt capital is the actual cost of debt, *i.e.* interest on debt; and (2) equity capital is based upon a fair return on its value, *i.e.* dividends or earnings.<sup>254</sup> For companies with

<sup>249</sup> CLWSC Ex. 32, p. 2088.

<sup>250</sup> ED-DL-1 Supp.

<sup>251</sup> 30 Tex. Admin. Code § 291.31(c)(1).

<sup>252</sup> Tex. Water Code § 13.183(a)(1) & (2).

<sup>253</sup> See Ron Moss, *Ratemaking in the Public Utility Commission of Texas*, 44 BAYLOR L. REV. 825 (1992).

<sup>254</sup> 30 Tex. Admin. Code § 291.31(c)(1)(C)(i) & (ii).

ownership expressed in terms of shares of stock, equity capital commonly consists of common stock capital and preferred stock capital.<sup>255</sup>

Before a rate of return can be fixed, the Commission must determine what percentage of the utility's cost of capital is debt and what percentage is equity capital. Once the percentage is set for each element, a weighted cost of capital is ascertained by multiplying that percentage amount by the cost of the particular element. The combined weighted values represent the overall rate of return which is then applied to the rate base.<sup>256</sup>

In addition to considering the utility's capital structure, the Commission must also consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management.<sup>257</sup> Moreover, in any proceeding involving any proposed change of rates, including rate of return, the burden of proof shall be on the utility to show that the proposed change is just and reasonable.<sup>258</sup>

The Commission must also apply the following regulatory principles in determining a fair rate of return:

- (A) The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

. . . .

- (C) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital.

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<sup>255</sup> 30 Tex. Admin. Code § 291.31(c)(1)(C)(ii)(I) & (II).

<sup>256</sup> CLWSC Ex. C, pp. 14-15.

<sup>257</sup> Tex. Water Code § 13.184(a) & (b); 30 Tex. Admin. Code § 291.31(c)(1)(B).

<sup>258</sup> Tex. Water Code § 13.184(c).

In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.<sup>259</sup>

Lastly, there are two United States Supreme Court rulings that are oft-cited as establishing the legal criteria for determining a fair rate of return for regulated industries such as utilities: *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia*<sup>260</sup> and *Federal Power Comm'n v. Hope Natural Gas Co.*<sup>261</sup> In *Bluefield*, the United States Supreme Court stated that:

A public utility is entitled to such rates as will permit it to earn a return on the value of property which it employs for the convenience of the public equal to that general being made . . . on investments in other business undertakings which are attended by corresponding risks and uncertainties.

In the *Hope* decision, the United States Supreme Court broadened the concept of a reasonable return to allow for increasing national competition for capital:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.

## **B. Contested Rate of Return Issues and Summary of Recommendation**

Essentially, two contested issues were raised in regards to the rate of return:

- Whether a low-interest, 2.25%, intercompany loan of \$11,250,000 should be factored into CLWSC's cost of debt? CLWSC contends that it did not have to include the loan in the application because it was a short-term loan from its parent company. If this debt is calculated into the weighted cost

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<sup>259</sup> 30 Tex. Admin. Code § 291.31(c)(1)(A) & (C).

<sup>260</sup> 262 U.S. 679 (1923).

<sup>261</sup> 320 U.S. 591 (1944).

of capital, it significantly impacts the cost of debt component and lowers the overall rate of return; and

- Whether the return on equity should be determined using TCEQ’s “Rate of Return Worksheet,” (worksheet) or by a market-based risk analysis? CLWSC claims that the worksheet favors small mom-and-pop water systems, rather than publicly-traded multi-regional corporations. If the worksheet, rather than a market risk analysis, is applied, the return on equity and overall rate of return is lowered.

Based on the evidence and argument, the ALJs agree with the ED and CEWR that the cost of debt component of the weighted cost of capital should include the low-interest intercompany loan. The ALJs also conclude that the worksheet meets the return on equity statutory and regulatory requirements, such as conservation, management, and efficiency. Applying the worksheet factors, the ALJs find that the return on equity should be set at 10.88%, rather than 9.88% as recommended by the ED, resulting in a 6.46% overall rate of return. The ALJs’ recommended calculations are as follows:

**Weighted Average Cost of Capital<sup>262</sup> with Three Debts and 10.88% Return on Equity**

Type- Debt or Equity (A)	Original Amount of Loan (B)	Outstanding or Unpaid Balance (C)	Rate (D)	Percentage (E)	Weighted Cost of Capital <sup>263</sup> (F)
(1) Debt Series A Notes	\$15,000,000	\$15,000,000	6.27%	38.77%	2.43%
(2) Debt BMET <sup>264</sup>	\$ 1,387,207	\$ 971,401	6.50%	2.51%	0.16%
(2A) Debt Notes payable SJW Corp. (intercompany)		\$11,250,000	2.25%	29.08%	0.65%
<b>(3) Total Debt</b>		<b>\$27,221,401</b>		<b>70.36%</b>	<b>3.24%</b>
(4) Equity		\$11,469,287 <sup>265</sup>	10.88%	29.64%	3.22%
<b>(5) Total Debt and Equity</b>		<b>\$38,690,688</b>		<b>100%</b>	<b>6.46%</b>

<sup>262</sup> CLWSC Ex. 1, p. 17, with additional debt added.

<sup>263</sup> In order to find the weighted cost of capital, the amount in column (C) is divided by the total amount of debt and equity in row (5) and then multiplied by the interest rate in column (D). All percentages are rounded to two decimal places, *i.e.* 6.27% is 0.0627.

<sup>264</sup> BMET stands for the Bexar Metropolitan Water District, aka Bexar Met.

<sup>265</sup> CLWSC Ex.1, p. 17.

### C. Cost of Debt Issue

The parties disagree on the characterization of the intercompany loan received from CLWSC's parent company, SJW Corp. Although CLWSC contends that it is a short-term loan with no repayment expected, the other parties assert that it was an actual debt that should be included in the cost of debt. The issue is important because the magnitude and interest rate of the loan changes the percentage of debt and impacts the rate of return. In other words, if just the two market-rate interest loans with 6.27% and 6.50% interest are included in the weighted cost of capital formula, with a 10.88% return on equity, then the company must be awarded a higher rate of return, or 8.204%, in order to generate funds to pay the market-rate debts and provide a return on equity.<sup>266</sup> But if all three debts, including the intercompany loan, are included in the weighted cost of capital formula, with a 10.88% return on equity, the overall rate of return would be 6.46%.

#### 1. CLWSC

CLWSC's Application listed only two debts: the Series A notes and the BMET loan.<sup>267</sup> This section of the Application had an asterisk with the notation "[w]orking capital loans from the parent company have been excluded in order to normalize the cost of capital for ratemaking purposes."<sup>268</sup> It is these "working capital loans" that are at issue. Mr. Jensen, who prepared the Application, explained that a short-term intercompany loan is not usually recognized in a company's capital structure for ratemaking purposes.<sup>269</sup>

According to Mr. Jensen, the capital loan from SJW Corp. was necessary because CLWSC was financially unable to issue any bond debt or raise equity on its own. He stated that,

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<sup>266</sup> These calculations assume a rate of return on equity at 10.88%, which is discussed in the next section of this PFD.

<sup>267</sup> Tr. pp. 1123-1125. The Series A notes are long-term bonds, and the BMET loan relates to the utility purchase.

<sup>268</sup> CLWSC Ex. 1, p. 17.

<sup>269</sup> Tr. p. 1323.

in reality, CLWSC will never be able to repay the loan.<sup>270</sup> He explained that the 2.25% interest is necessary either to provide a dividend to shareholders,<sup>271</sup> or pay the short-term line of credit interest SJW Corp. owes its bank.<sup>272</sup> SJW Corp.'s line of credit must be paid off every two years in order to qualify for favorable interest rates, according to Mr. Jensen.<sup>273</sup> He also noted that CLWSC has not paid anything on the loan so far.<sup>274</sup>

In its closing arguments, CLWSC asserts that the application requires listing only long-term debt; that long-term debt cannot be attained for 2.25%; and there was no expectation of repayment of the loan. Further, CLWSC points out that inclusion of the loan would reduce the rate of return to below the market-rate interest rate of the other two debts.

## 2. ED

Ms. Loockerman testified that she included the loan in the cost of debt based on the intercompany notes payable worksheet (intercompany worksheet) provided by CLWSC.<sup>275</sup> Specifically, the intercompany worksheet showed that the loan amount and accrued interest grew from May 1, 2007, until December 31, 2010, when substantial capital investment was being made in Texas. She testified that a note is classified as long term if it last more than one year.<sup>276</sup>

Further, Ms. Loockerman noted that CLWSC listed the debt on a separate "statement of cash flow," under the heading "borrowing from a line of credit."<sup>277</sup> She noted that the debt was on the books from 2007 to 2010, and thus, is considered long-term.<sup>278</sup>

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<sup>270</sup> Tr. p. 216.

<sup>271</sup> Tr. p. 217.

<sup>272</sup> Tr. p. 1323.

<sup>273</sup> Tr. p. 1322.

<sup>274</sup> Tr. p. 218.

<sup>275</sup> ED-DL-42.

<sup>276</sup> ED-DL-1, p. 23.

<sup>277</sup> ED-DL-22.

<sup>278</sup> ED-DL-1, p. 23.

### 3. CEWR

Because Mr. Jensen confirmed in cross-examination that CLWSC is under a legal obligation to repay the loan and the loan was listed on the financial statement of SJW Corp. as an intercompany loan, CEWR argues that the loan should be included in the cost of debt.<sup>279</sup> CEWR also contends that if it were an intercompany transfer, no interest would be due.

### 4. OPIC

OPIC concurs that the loan should be included in the rate of return calculation.

### 5. ALJs' Analysis

The ALJs conclude that CLWSC has not met its burden of proof to show that the rate of return should not include the intercompany loan. There are numerous reasons for this conclusion.

Contrary to CLWSC's argument for not listing the loan in the Application, the Commission's rules do not distinguish long-term or short-term debt for exclusion in the rate of return. Rather, 30 Tex. Admin. Code § 291.31(c)(1) provides that the Commission shall consider the utility's *entire* cost of capital, including debt capital, or "the actual cost of debt." Thus, if the loan was an actual debt, it must be included in the cost of debt capital, regardless of whether it is a long-term or short-term loan.

Because the definition of actual debt is not provided, under the rules of statutory construction and agency rule interpretation, undefined terms are understood by their ordinary meaning.<sup>280</sup> In this context, both the common dictionary<sup>281</sup> and legal dictionary<sup>282</sup> define

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<sup>279</sup> Tr. p. 1355.

<sup>280</sup> *In re Canales*, 52 S.W. 3d 698, 702 (Tex. 2001); Tex. Gov't Code §§ 311.002(4) & 311.011.

<sup>281</sup> Webster's Third New International Dictionary at 22 (1993).

<sup>282</sup> Black's Law Dictionary at 38 (8th Ed. 2004).

“actual” similarly: relating to acts or deeds and existing in act, fact, or reality. The definition of debt is lengthy but uniformly includes something that one person is bound to pay to another,<sup>283</sup> and liability on a claim due by agreement or otherwise.<sup>284</sup> By these definitions, there is sufficient evidence to conclude that CLWSC owes an actual debt to SJW Corp.

First, the evidence established that CLWSC acted inconsistently with the position that the loan was, in reality, an intercompany transfer with no expectation of repayment. For instance, the loan has been on the books from May 1, 2007, until December 31, 2010, with the balance increasing from \$1 million to \$11,210,000 and the interest incrementally increasing in relation to the balance. The intercompany worksheet showed that the interest was payable monthly, and CLWSC made payments on the loan: \$2,000,000 on August 20, 2007; \$500,000 on January 22, 2009; and \$600,000 on August 24, 2009.<sup>285</sup> Further, the balance was never reduced to zero, which would substantiate that it was a short term line of credit that was paid or written off. Instead the loan was handled like an actual debt with interest and payments due. Lastly, the loan cannot be classified as a short-term loan when it has been in existence for three years, from 2007 through 2010, with payments made and interest accrued monthly.<sup>286</sup>

Second, during the test year from March 31, 2009, through March 31, 2010, the debt increased from \$9,850,000, with a monthly interest accrual of \$18,334.38, to \$11,250,000, with a monthly interest accrual of \$21,796.88. During the same time period, there were five payments recorded, totaling \$1.3 million. Although these loans may have been working capital loans, it still appears that the loans should have been included in the cost of capital for ratemaking purposes.

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<sup>283</sup> Webster’s Third New International Dictionary at 583 (1993).

<sup>284</sup> Black’s Law Dictionary at 432 (8th Ed. 2004).

<sup>285</sup> ED-DL-42, p. 405194.

<sup>286</sup> ED-DL-1, p. 23.

Third, CLWSC listed the debt on its statements of cash flow as “borrowing from a line of credit,” and listed it in a column marked as “financing activities.”<sup>287</sup> These statements were dated December 31, 2007, to December 31, 2010. The use of the words “borrowing” or “financing” implies that there was an understanding that the loan must be repaid, which is validated by actions such as payments and accrued interest due. Finally, Mr. Jensen confirmed that the loan was listed on the SJW Corp. financial statements and admitted that SJW Corp. was entitled to repayment. Listing the loan on financial statements confirms the intent of the parties on the issue of repayment.

Accordingly, CLWSC had the burden of proof to show that its proposed rates are just and reasonable. This burden includes proving that its proposed cost of debt was accurate and complied with the TCEQ’s rules. CLWSC failed to meet that burden. Accordingly, the ALJs find that the rate of return should include the actual debt of \$11,250,000 at 2.25% interest.

**D. Return on Equity Issue**

The ALJs now consider whether the return on equity should be calculated using the return on equity worksheet as proposed by the ED, CEWR, and OPIC, or by applying a market-based risk analysis, as advocated by CLWSC. Specifically, CLWSC requests that the return on equity be set at 12%, while the opposing parties suggest 9.88% is appropriate. The ALJs conclude that the worksheet presents a fair and reasonable methodology consistent with statutory and regulatory considerations. Applying the worksheet, in combination with the testimony and evidence concerning all factors, the ALJs conclude that an additional 1% should be added to the ED’s worksheet calculation, resulting in a return on equity of 10.88%.

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<sup>287</sup> ED-DL-22, pp. 407049-407052.

1. CLWSC

CLWSC requested an overall weighted rate of return of 8.673%, including a 12% rate of return on equity. The calculations are as follows:

**Weighted Average Cost of Capital with Two Debts and 12.00% Return on Equity**

Type- Debt or Equity (A)	Original Amount of Loan (B)	Outstanding Balance (C)	Rate (D)	Percent age (E)	Weighted Cost of Capital <sup>288</sup> (F)
(1) Debt Series A Notes	\$15,000,000	\$15,000,000	6.27%	54.66%	3.427%
(2) Debt BMET	\$ 1,387,207	\$ 971,401	6.50%	3.54%	0.230%
<b>(3) Total Debt</b>		<b>\$15,971,401</b>			<b>3.657%</b>
(4) Equity		\$11,469,287 <sup>289</sup>	12.00%	41.80%	5.016%
<b>(5) Total Debt and Equity</b>		<b>\$27,440,688</b>		<b>100%</b>	<b>8.673%</b>

In support, CLWSC presented the testimony of Gregory E. Scheig, CPA, and Principal of ValueScope, Inc., a financial advisory service company.<sup>290</sup> Mr. Scheig testified that he prepared three models for properly estimating the cost of equity in the application: (1) the capital asset pricing model (CAPM); (2) the discounted cash flow (DCF) method; and (3) risk premium method (RPM).

Mr. Scheig explained that he based his recommendation on a combination of the three models and determined the appropriate return on equity would be in the range of 12.6% to 14.4%.<sup>291</sup> He characterized the requested 12% rate in the application as conservative, but refuted that the worksheet was appropriate in this case. Briefly, Mr. Scheig testified as follows:

<sup>288</sup> In order to find the weighted cost of capital, the amount in column (C) is divided by the total amount of debt and equity in row (5) and then multiplied by the interest rate in column (D). All percentages are rounded to two decimal places; *i.e.* 6.27% is 0.0627.

<sup>289</sup> CLWSC Ex. 1, p. 17; CLWSC Ex. E, p. 18.

<sup>290</sup> CLWSC Ex. 20.

<sup>291</sup> CLWSC Ex. E, p. 7.

- The CAPM is the most widely used tool for estimating the cost of equity and is determined based on: (a) the 20-year Treasury bond rate; (b) a market risk premium; (c) an index of systemic risk; (d) a small stock risk premium (SSRP); and (e) a company specific risk premium (CSRP). Using this method, the required rate of return on equity range of 11.9% to 12.1% would be appropriate, plus an SSRP of 1.1% and CSRP of 0.5%.<sup>292</sup>
- As far as the DCF analysis, he used average stock prices from large publicly-traded utility companies (Aqua America, American States Water, Southwest Water, and California Water).<sup>293</sup> Using this method, the return on equity ranged from 10.5% to 10.9%, prior to the inclusion of an SSRP of 1.1% and CSRP of 0.5%.<sup>294</sup>
- The RPM involved a comparison between electric and gas utility authorized return on equity to long-term utility debt rates.<sup>295</sup> He compared electric utility data from 1990 through 2009, as shown in two publications. He calculated an equity risk premium of 4.1% to 4.2%, Baa-rated utility debt, and cost of debt of 6.50%.<sup>296</sup> Using this method, the return on equity ranged from 11.0-12.0%, plus an SSRP of 1.1% and CSRP of 0.5%.<sup>297</sup>

Regarding the worksheet, Mr. Scheig pointed out the following perceived flaws: the worksheet begins with the Baa bond average, the lowest-investment grade cost of debt,<sup>298</sup> the time period of the Baa is unclear, either as the test year, time of application, or date of the hearing,<sup>299</sup> and a system with 201 customers is treated the same as 200,000 customers.<sup>300</sup> Further, he contended that the ED's rate of return worksheet should be rejected because the water utility business is very capital intensive, has a slow growth rate, and has high regulatory and environmental hazard risks. CLWSC has had to expend a significant amount of capital since

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<sup>292</sup> CLWSC Ex. E, p. 23 & 30; CLWSC Ex. 30.

<sup>293</sup> CLWSC Ex. E, p. 23.

<sup>294</sup> CLWSC Ex. E, p. 31.

<sup>295</sup> CLWSC Ex. E, p. 24.

<sup>296</sup> CLWSC Ex. E, p. 25.

<sup>297</sup> CLWSC Ex. E, p. 31.

<sup>298</sup> CLWSC Ex. E, p. 32. The bonds are designated by letters, representing creditworthiness.

<sup>299</sup> CLWSC Ex. E, p. 34.

<sup>300</sup> CLWSC Ex. E, p. 34.

2006 in order to bring the systems up to modern standards and maintain compliance.<sup>301</sup> He also testified that his methodology offered a return on equity comparable to returns from other investments of similar risks. Further, CLWSC argued that a 12% rate of return on equity has been granted in other TCEQ cases.

On cross-examination, Mr. Scheig confirmed that SJWC had a 10.2% return on equity set by the California Public Utility Commission and had agreed to a 9.99% return on equity in another settled case.<sup>302</sup> Mr. Scheig also agreed that the California methodologies did not consider conservation of resources, quality of service, efficiency, and good management.<sup>303</sup>

Although CLWSC relies on Mr. Scheig's testimony to establish its rate of return, Mr. Hodge, the local general manager of CLWSC, also provided input information for the worksheet.<sup>304</sup> He agreed with the ED's worksheet factors except in two instances: (1) CLWSC has an unstable population in that more than 25% of the total customers are weekenders or seasonal customers; and (2) commercial customers account for more than 15% of revenues.<sup>305</sup>

## 2. ED

Ms. Loockerman testified that she used the worksheet to calculate a return on equity of 9.88%.<sup>306</sup> She testified that she used the following process:

- She started with the Mergent Bond Record publication for Corporate Bond Yield averages.<sup>307</sup>

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<sup>301</sup> CLWSC Ex. C, pp. 74-75.

<sup>302</sup> Tr. p. 820.

<sup>303</sup> Tr. pp. 569 & 892-893.

<sup>304</sup> CLWSC Ex. B, pp. 52-54.

<sup>305</sup> CLWSC Ex. B, pp. 52-54.

<sup>306</sup> ED-DL-1, p. 23.

<sup>307</sup> ED-DL-26.

- She averaged the Baa bond rating for public utilities for the test year of April 2009 through March 2010 and the result was 6.63%.<sup>308</sup> She explained that the Baa bond rating is used because it is the rating published with the highest risk for public utilities.<sup>309</sup>
- She then added 3.00 points to this rate to recognize the increased risk of a smaller business and good management practice of CLWSC.<sup>310</sup> She added the 0.25 in bonus points for good management practices observed at CLWSC for a total of 3.25. The resulting return of equity totaled 9.88%.<sup>311</sup>
- She reviewed past TCEQ decisions and documents from other states for consistency and noted that Texas has had only one other large sophisticated rate case with similar issues.<sup>312</sup>

In his closing arguments, the ED asserts that the worksheet captures the following factors: the small stock premium; high debt/equity ratio; unstable population; quality of service, efficiency, and good management; good customer relations; and conservation. The ED also points out that the Application states that if the case is referred to hearing, then the ED will determine the rate of return using the worksheet.<sup>313</sup>

### 3. CEWR

CEWR agrees with the ED's calculation using the worksheet, with the exception of the 0.25 points for good management. CEWR argues that because SJW Corp. is the sole stockholder, the ability to attract capital will not be affected.

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<sup>308</sup> ED-DL-1, p. 23.

<sup>309</sup> ED-DL-1, p. 23.

<sup>310</sup> ED-DL-1, p. 23.

<sup>311</sup> ED-DL-5, p. 3.

<sup>312</sup> ED-DL-27; ED-DL-28; ED-DL-31; ED-DL-1, p.25.

<sup>313</sup> CLWSC Ex. 45; Tr. pp. 1208-1209.

**4. OPIC**

OPIC agrees with the ED.

**5. ALJs' Analysis**

The ALJs conclude that the return on equity should be set at 10.88% based on the worksheet, which includes an additional 1% increase for the risk associated with a seasonal population and the commercial businesses supporting that population.

The ALJs find that the worksheet provides a fair and reasonable method to calculate the return on equity. Unlike Mr. Scheig's three models, the worksheet applies the rate of return principles set out in the Texas Water Code and the current rules.<sup>314</sup> It ensures access to credit and equity markets by starting with the current rate of return on publicly-traded bonds, which reflects debt with very low risk. The worksheet also allows for upward adjustments to reflect systems with higher risks to capital, including systems with low growth, unstable populations, and aging facilities. Upward adjustments are also allowed when a utility's management conserves water resources and provides high quality of service and good management.

The worksheet method is also consistent with the historical practice. Given the current 6.63% Baa bond rate and the possibility of upward adjustments totaling 8.0%, the calculation methodology set out in the worksheet allows for the possibility of a 14.63% rate of return. That would be consistent with the argument that the Commission has approved rates of return of 12%. Lastly, each of the lines on the worksheet operates to allow consideration of the *Bluefield* constitutional requirement that a utility should be allowed a return that is similar in nature to a comparable enterprise, including various risk factors.

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<sup>314</sup> Tex. Water Code § 13.184(b); 30 Tex. Admin. Code § 291.31(c)(1).

Ms. Loockerman calculated the rate of return of 9.88%, with no upward adjustment for a reasonable population or a large number of commercial customers. She did not explain the reason that she included or excluded any of the worksheet factors, nor did she articulate the basis for the good management 0.25% bonus points. On the other hand, Mr. Hodge is familiar with the day-to-day operations of the utility, including the types of customers and businesses. He testified that CLWSC serves a recreational lake area with associated businesses. The ALJs conclude that Mr. Hodge presented solid reasons, which were uncontroverted, for a 1% upward adjustment due to increased risk. Accordingly, the ALJs conclude that 10.88% rate of return on equity is both reasonable and consistent with applicable law.

#### **E. Summary of ALJs' Recommendations**

To summarize, the ALJs agree with the ED and CEWR that the intercompany loan should be factored into CLWSC's cost of debt. Because the worksheet presents the best method to calculate a fair and reasonable return, the ALJs conclude that the return on equity should be set at 10.88%, for an overall rate of return of 6.46%. As set forth in this PFD, the ALJs conclude that CLWSC's rate base is \$38,096,384; thus, its annual return should be \$2,461,026, which is 6.46% of \$38,096,384.

### **VII. RATE COLLECTION TRUE-UP**

On August 27, 2010, CLWSC mailed a Notice of Proposed Rate Change to its customers.<sup>315</sup> The notice contained the following statement:

In accordance with Commission rules, CLWSC will begin charging the rates marked below as "Phase 1" on October 27, 2010. If the Commission denies the depreciation request or has not acted on it by March 15, 2011, *CLWSC will begin charging the rates marked below as "Phase 2" on March 15, 2011.* If the Commission approves the depreciation request before March 15, 2011, CLWSC will continue to charge the Phase 1 rates until a final order is entered on the rate

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<sup>315</sup> CLWSC Ex. A, pp. 33-39.

change application. At that time, CLWSC will change its rates to the rates set forth in that final order. CLWSC will issue new customer notices before changing from the Phase 1 rates to the Phase 2 rates or to the final TCEQ approved rates.<sup>316</sup>

CLWSC seeks to have the rates determined in the hearing relate back to October 27, 2010, the effective date of the Phase 1 rates. However, CLWSC did not provide notice to its customers that the Phase 2 rates would go into effect on that date. CLWSC notified its customers that the Phase 2 rates would go into effect, if at all, on March 15, 2011. The TCEQ rules provide that a utility must provide notice to its customers regarding the effective date of the new rates and “the new rates may not apply to service received before the effective date of the new rates.”<sup>317</sup> Only the Phase 1 rates were noticed to be effective on October 27, 2010. The Phase 2 rates are the requested final rates and they were to go into effect on March 15, 2011. Also, neither 30 Tex. Admin. Code § 291.29 regarding interim rates nor Order No. 2 setting interim rates in this case addresses the issue of when CLWSC’s final rates go into effect. Therefore, consistent with the notice CLWSC issued to its customers, the ALJs recommend that any true-up in this proceeding relate back to the noticed effective date of the Phase 2 rates, March 15, 2011. In the event that the final rates are lower than the Phase 1 rates, the ALJs recommend that CLWSC refund to its customers the over-collection of rates since October 27, 2010, the noticed effective date of the Phase 1 rates.

### VIII. RATE DESIGN

Given the ALJs’ recommendations regarding CLWSC’s fixed and variable costs, the ALJs are unable to recommend a rate structure that will recover CLWSC’s revenue requirement. Therefore, the ALJs request the ED, when he files his exceptions, to provide the Commission with a calculation of rates with base rates and volumetric rates designed to recover the revenue requirement recommended in this PFD. The ALJs recommend that the ED use the allocations between base rates and volumetric rates found in ED-KA-5.

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<sup>316</sup> CLWSC Ex. A, p. 34 (emphasis added).

<sup>317</sup> 30 Tex. Admin. Code § 291.22(a)(1).

**IX. SUMMARY OF ALJS' RECOMMENDATION**

In summary, the ALJs recommend that the Commission approve CLWSC's application for a water rate change as proposed in the Application as modified by the recommendations in this PFD. With a rate of return of 6.46%, the ALJs make the following recommendations:

**Rate Base**

<b>Item</b>	<b>Amount</b>
Original Cost	\$64,206,901
Accumulated Depreciation	<11,248,826>
<b>Net Book Value</b>	<b>\$52,958,075</b>
Working Cash Allowance	625,726
Materials and Supplies	361,235
Prepayments	4,900
ADFIT	<268,037>
Developer CIAC	<14,812,965>
Advances	<772,550>
<b>Rate Base (Total Invested Capital)</b>	<b>\$38,096,384</b>

**Revenue Requirement**

<b>Item</b>	<b>Amount</b>
Salaries and Wages	\$1,084,931
Contract Labor	289,988
Purchased Water	1,141,619
Chemicals	91,100
Utilities	459,763
Repairs/Maintenance/Supplies	996,704
Office Expenses	332,128
Accounting and Legal Fees	84,359
Insurance	311,422
Miscellaneous	213,798
<b>Total O&amp;M</b>	<b>\$5,005,812</b>
Taxes Other than Income	284,037
Annual Depreciation and Amortization	1,897,872
Income Taxes	
Return	2,461,026
Less Other Revenues	<1,124,163>
<b>Total Revenue Requirement</b>	

## X. REGULATORY APPROVALS

CLWSC requests that the TCEQ provide two regulatory approvals of assets taken out of CLWSC's rate base for ratemaking purposes. These assets are still shown on CLWSC's books and are subject to amortization. CLWSC requests approval of its acquisition balances and its plant held for future use (PHFU), and claims that these two approvals are necessary for auditing purposes. In its response to the parties' closing arguments, CLWSC states that approval of these two requests will have no impact on the rates established in this case.<sup>318</sup>

### A. Acquisition Adjustments

CLWSC requests a finding that it has an acquisition adjustment balance of approximately \$4 million that resulted from various acquisitions of water systems within the Canyon Lake area. CLWSC seeks approval that this amount may be carried on its books and amortized "until such time as the amounts are no longer on CLWSC's books or they are included for ratemaking purposes in a future rate case."<sup>319</sup>

For CLWSC's accounting purposes, CLWSC defined an acquisition adjustment as "[a]ny amount paid over or under the utility plant original cost (less accumulated depreciation)."<sup>320</sup>

Mr. Loy testified:

I excluded the total \$4 million negative [acquisition adjustment] balance from CLWSC's rate base. CLWSC would like to retain these asset costs on its books while amortizing them "below the line" (i.e., not include them in rates). This is properly accomplished by placing the amount in an [acquisition adjustment] account on CLWSC's books which requires regulatory approval. Therefore, CLWSC requests, as appropriate, that TCEQ specifically find that the \$4 million dollars is properly classified as [an acquisition adjustment] on CLWSC's books and can be used to offset other future positive acquisition adjustments that may be

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<sup>318</sup> CLWSC Response, p. 30.

<sup>319</sup> CLWSC Closing, p. 60; CLWSC Ex. C, p. 24.

<sup>320</sup> CLWSC Ex. C, p. 23.

incurred in future acquisitions. This reasonable regulatory approval will allow CLWSC to continue carrying this amount on its books, amortize it below the line and achieve compliance with Generally Accepted Accounting Principles (GAAP).<sup>321</sup>

Mr. Loy claims that if the TCEQ does not grant this regulatory approval, auditors in the future might be required to find that the \$4 million dollars of assets are non-recoverable and should be written off, causing CLWSC a significant reduction in earnings.<sup>322</sup>

The ED objects to this regulatory approval because the negative acquisition adjustment should be incorporated into CLWSC's rate base.<sup>323</sup> However, in Ms. Loockerman's testimony, she said regarding acquisition adjustments:

In regard to capital invested (rate base), I recommend that rate base, as requested in the application, be reduced by cost-free capital provided by the net acquisition adjustment. The adjusted rate base should be used to determine the return on invested capital and the *acquisition adjustments should be amortized* using CLWSC calculated dollar figures.<sup>324</sup>

Therefore, it appears as if Ms. Loockerman agrees with CLWSC's request to amortize the acquisition adjustment, although it is unclear if her agreement is conditioned on the inclusion of the negative acquisition adjustment in rate base.

There is very little testimony and briefing regarding this issue. CLWSC's request seems reasonable, and Ms. Loockerman's testimony seems to support CLWSC's request to amortize the acquisition adjustment. Therefore, the ALJs recommend that the TCEQ issue the regulatory approval as requested by CLWSC.

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<sup>321</sup> CLWSC Ex. C, p. 24.

<sup>322</sup> CLWSC Ex. C, p. 25.

<sup>323</sup> ED Closing, pp. 44-45.

<sup>324</sup> ED-DL-1, p. 20 (emphasis added).

**B. Plant Held for Future Use**

CLWSC requests approval of the costs that represent what CLWSC paid to purchase the Bexar Met CCN. Although CLWSC has not included this amount in its rate base in this proceeding, it may seek to include the cost in a future rate case when customers within the CCN area are added to the CLWSC water system.

There appears to be an inconsistency in CLWSC's PHFU request. Mr. Loy testified that he removed \$3.1 million from the rate base for the cost of the CCN CLWSC purchased from Bexar Met.<sup>325</sup> In its closing arguments, CLWSC requested approval of the PHFU for the CCN it purchased for \$3.2 million from GBRA for the Bulverde CCN.<sup>326</sup> However, both Mr. Adhikari and Mr. Loy removed \$3,237,890 from the original cost calculation.<sup>327</sup>

The ED objects to the extent the CCN is considered plant and would be included in rate base instead of being amortized.

The ALJs agree with CLWSC that the TCEQ should approve the request. As the ALJs understand the request, whether to include the cost of the Bexar Met/Bulverde CCN in CLWSC's rate base will be decided in a future rate case and will have no impact on the rates resulting from this proceeding. Although the ALJs recommend approval of CLWSC's request, the ALJs make no recommendation as to whether a CCN is more in the nature of an expense to be amortized or more in the nature of an asset to be included in rate base.

**XI. RATE CASE EXPENSES**

On August 22 and 23, 2012, the ALJs reconvened the hearing to take evidence regarding CLWSC's rate case expenses. CLWSC provided testimony from two of its attorneys,

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<sup>325</sup> CLWSC Ex. C, p. 22.

<sup>326</sup> CLWSC Closing, p. 31.

<sup>327</sup> ED-KA-6.

Paul Terrill and Mark H. Zeppa. Mr. Jensen, Mr. Scheig, and Mr. Loy also testified on the propriety of CLWSC's claimed rate case expenses. The ED presented one witness, Ms. Loockerman, who made recommendations regarding adjustments to CLWSC's requested rate case expenses. Neither CEWR nor OPIC presented a witness to testify on this issue.

As of July 2012, CLWSC asserts that it has incurred \$971,758.39 in reasonable and necessary rate case expenses.<sup>328</sup> Among those expenses are attorneys' fees and consulting fees. The table below summarizes CLWSC's evidence of its actual rate case expenses:

<b>Expense</b>	<b>Amount</b>
GDS Associates, Inc. <sup>329</sup>	\$481,766.49
ValueScope, Inc. <sup>330</sup>	55,213.75
The Terrill Firm, P.C. <sup>331</sup>	361,344.74
Law Offices of Mark H. Zeppa <sup>332</sup>	69,053.21
Expenses <sup>333</sup>	4,380.17
<b>Total</b>	<b>\$971,758.39</b>

#### A. Applicable Law

The Texas Legislature has authorized the TCEQ to adopt reasonable rules with respect to the disallowance of certain ratemaking expenses.<sup>334</sup> However, the legislature has disallowed certain expenses, including "any expenditure found by the [TCEQ] to be unreasonable, unnecessary, or not in the public interest, including . . . legal expenses . . ."<sup>335</sup> In its rules, the TCEQ has provided that "[a] utility may recover rate case expenses, including attorney fees,

<sup>328</sup> CLWSC Ex. 78.

<sup>329</sup> CLWSC Ex. 74.

<sup>330</sup> CLWSC Ex. 75.

<sup>331</sup> CLWSC Ex. 72.

<sup>332</sup> CLWSC Ex. 73.

<sup>333</sup> CLWSC Ex. 76.

<sup>334</sup> Tex. Water Code § 13.185(g).

<sup>335</sup> Tex. Water Code § 13.185(h).

incurred as a result of a rate change application only if the expenses are reasonable, necessary, and in the public interest.”<sup>336</sup>

**B. The “Public Interest” and Reasonable and Necessary Attorneys’ Fees**

**1. CLWSC**

CLWSC takes issue with the “public interest” component of the rate case expense analysis. Further, CLWSC argues that the ED’s witness Ms. Loockerman is not qualified to present testimony regarding the propriety of CLWSC’s attorneys’ fees.

CLWSC claims that its two attorneys, Mr. Terrill and Mr. Zeppa, are the only qualified witnesses who testified regarding CLWSC’s attorneys’ fees, and these two witnesses testified that the attorneys’ fees were reasonable and necessary. CLWSC maintains that any reduction of an otherwise reasonable and necessary rate case expense based on the undefined and ambiguous term “public interest” would be confiscatory, as well as arbitrary and capricious.<sup>337</sup>

CLWSC relies on *Arthur Anderson & Co. v. Perry Equip. Corp.*<sup>338</sup> for the proposition that “the Texas Supreme Court requires use of the factors set forth in the Texas Disciplinary Rules of Professional Conduct [TDRPC], 1.04(b) to determine reasonableness and necessity of attorneys’ fees.”<sup>339</sup> In reliance on *Arthur Anderson*, CLWSC claims that the factors found in rule 1.04(b) of the TDRPC apply to this proceeding.<sup>340</sup>

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<sup>336</sup> 30 Tex. Admin. Code § 291.28(7).

<sup>337</sup> CLWSC Rate Case Expense (RCE) Closing, p. 3.

<sup>338</sup> 945 S.W.2d 812, 818 (Tex. 1997).

<sup>339</sup> CLWSC RCE Closing, p. 5.

<sup>340</sup> Rule 1.04(b) of the TDRPC provides: “[f]actors that may be considered in determining the reasonableness of a[n attorney] fee include, but not to the exclusion of other relevant factors, the following: (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly; (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer; (3) the fee customarily charged in the locality for similar legal services; (4) the amount involved and the results obtained; (5) the time limitations imposed by the client or by the circumstances; (6) the nature and length of the professional relationship with the client; (7) the experience, reputation, and ability of the

CLWSC also asserts that only attorneys can provide testimony regarding the factors specified in the TDRPC.<sup>341</sup> According to CLWSC, the testimony of its two attorneys is uncontroverted by a qualified witness, and therefore, must be taken as true.<sup>342</sup>

## 2. ED

The ED argues that CLWSC is wrong on the law regarding rate case expenses. The ED points out that CLWSC does not rely on cases that involve the determination of rate case expenses in the regulatory context, nor do any of CLWSC's cases require the consideration of the public interest in determining the propriety of an attorneys' fee.<sup>343</sup> According to the ED, the cases that apply to this proceeding are those that concern a rate case proceeding, such as *Industrial Utils. Serv., Inc. v. Texas Natural Res. Conservation Comm'n*,<sup>344</sup> *West Tex. Utils. Co. v. Office of Pub. Util. Counsel*,<sup>345</sup> and *Texas Water Comm'n v. Lakeshore Util. Co., Inc.*<sup>346</sup> The ED contends that, pursuant to applicable case law, non-attorneys may testify on whether attorneys' fees are in the public interest, which is a separate and distinct component in the analysis on the recovery of rate case expenses.

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lawyer or lawyers performing the services; and (8) whether the fee is fixed or contingent on results obtained or uncertainty of collection before the legal services have been rendered.”

<sup>341</sup> CLWSC RCE Closing, p. 6. At the hearing, CLWSC objected to Ms. Loockerman's testimony on the basis that she is not an attorney, and the ALJs overruled that objection. Tr. p. 1788-1791.

<sup>342</sup> CLWSC RCE Closing, p. 7.

<sup>343</sup> ED RCE Reply, p. 10.

<sup>344</sup> 947 S.W.2d 712, 716-17 (Tex. App.—Austin 1997, writ denied) (upholding agency order containing a conclusion of law that the rate case expenses were not in the public interest when agency determined that applicant's legal expenses were a waste of resources).

<sup>345</sup> 896 S.W.2d 261 (Tex. App.—Austin 1995, no writ) (upholding PUC's decision to impose a surcharge on two cities to recover the electric utility's rate case expenses).

<sup>346</sup> 877 S.W.2d 814, 825-26 (Tex. App.—Austin 1994, writ denied) (upholding agency's denial of rate case expenses, stating that Tex. Water Code § 13.185(h) gives the Commission “the discretion to disallow improper legal expenses, provided the Commission does not do so arbitrarily.”).

### 3. ALJs' Analysis

The ALJs agree with the ED's analysis of the legal issues presented by CLWSC's positions on the public interest and attorneys' fees. The purpose of chapter 13 of the Texas Water Code is to protect the public interest through the regulation of water and sewer utilities.<sup>347</sup> To that end, the TCEQ has "all authority and power of the state to ensure compliance" from utilities, and is empowered to "fix and regulate [the] rates of utilities . . . ."<sup>348</sup> The TCEQ has the discretion to disallow improper legal expenses, provided it does not act arbitrarily.<sup>349</sup>

The cases cited by CLWSC do not apply to the situation at hand. As pointed out by the ED, none of the cases cited by CLWSC require a determination of whether the legal fees are in the public interest. The term "public interest" has been discussed by at least two courts, which have upheld the agencies' actions on the basis of the public interest.<sup>350</sup> The public interest is the foundation for the TCEQ's regulation of utilities under chapter 13 of the Texas Water Code. The public interest is a necessary, statutory component that the ALJs cannot ignore because the term lacks a statutory definition. Although the term is undefined and ambiguous, as found by the supreme court,<sup>351</sup> the ALJs must nevertheless give effect to all words in the statute and may not treat any statutory language as surplusage.<sup>352</sup> Further, it is within the TCEQ's authority and expertise to balance the competing interests of the parties to decide what is in the public interest in a particular case, and the TCEQ has broad discretion to determine what factors to consider in making that determination.<sup>353</sup>

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<sup>347</sup> Tex. Water Code § 13.001(a).

<sup>348</sup> Tex. Water Code § 13.181(b).

<sup>349</sup> *Lakeshore Util.*, 877 S.W.2d at 825-26.

<sup>350</sup> See generally *Railroad Comm'n v. Texas Citizens for a Safe Future and Clean Water*, 336 S.W.3d 619, 628 (Tex. 2011) (construing the term "public interest" in the context of the issuance of a permit for an injection well); *Public Util. Comm'n v. Texas Tel. Ass'n*, 163 S.W.3d 204, 213 (Tex. App.—Austin 2005, no pet.) (considering scope of PUC's authority to determine whether the designation of an additional carrier in a rural area is within the public interest).

<sup>351</sup> *Railroad Comm'n v. Texas Citizens for a Safe Future and Clean Water*, 336 S.W.3d at 628.

<sup>352</sup> *Id.* at 629 n.12.

<sup>353</sup> Cf. *Public Util. Comm'n v. Texas Tel. Ass'n*, 163 S.W.3d at 213.

Regarding the issue of attorneys' fees, the Texas Supreme Court case of *Arthur Anderson* does not limit evidence of attorneys' fees in this case to the factors listed in rule 1.04(b) of the TDRPC. The supreme court held that the factors a court "*should consider* when determining the reasonableness of a fee *include*" those factors found in rule 1.04(b).<sup>354</sup> In an unpublished opinion cited by CLWSC, the court of appeals clarified that while a factfinder "*should consider*" the *Arthur Anderson* factors, a court is not required to consider all the rule 1.04(b) factors and may "look at the entire record, the evidence presented on reasonableness, the amount in controversy, the common knowledge of the participants as lawyers and judges, and the relative success of the parties."<sup>355</sup> Therefore, the ALJs conclude that they are not required to consider only those factors listed in *Arthur Anderson*, and can consider other evidence found in the entire evidentiary record.

Further, the ALJs do not agree with CLWSC's position that only attorneys can testify regarding attorneys' fees in this case. CLWSC relies on cases that determined that lay witnesses cannot testify to the reasonableness and necessity of attorneys' fees.<sup>356</sup> However, the cases cited by CLWSC do not address whether a witness with expertise in another area, such as a CPA, can testify regarding attorneys' fees. Also, CLWSC does not cite to a case that addresses attorneys' fees in the regulatory context, where an agency must determine whether rate case expenses are not only reasonable and necessary, but are also in the public interest. Expert testimony about attorneys' fees by CPAs is a common occurrence at the TCEQ as demonstrated by CLWSC's own actions. CLWSC's witness, Mr. Loy, is a CPA with many years of experience testifying in rate cases. On CLWSC's behalf, he testified that all of CLWSC's expenses, including attorneys'

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<sup>354</sup> *Arthur Anderson*, 945 S.W.2d at 818 (emphasis added).

<sup>355</sup> *Horvath v. Hagey*, 2011 Tex. App. LEXIS 3451 (Tex. App.—Austin 2011, no writ).

<sup>356</sup> *Horvath v. Hagey*, 2011 Tex. App. LEXIS 3451 (Tex. App.—Austin 2011, no writ) (wife in divorce action could not provide lay testimony regarding reasonableness of attorneys' fees); *Cantu v. Moore*, 90 S.W.3d 821, 826 (Tex. App.—San Antonio 2002, pet. denied) (a party who was not an attorney was not an expert who could testify to reasonableness and necessity of attorneys' fees); *Lesikar v. Rappeport*, 33 S.W.3d 282, 307 (Tex. App. — Texarkana 2000, pet. denied) (party in a fraud action only testified regarding reasonableness of an attorney's services, "there was no testimony, *expert or otherwise*, regarding whether [attorneys'] fees were reasonable and necessary." (emphasis added)); *Woollett v. Matyastik*, 23 S.W.3d 48, 53 (Tex. App. — Austin 2000, pet. denied)(lay witness's unsupported testimony regarding reasonableness and necessity of attorneys' fees is not sufficient).

fees, were reasonable and in line with fees in other cases.<sup>357</sup> Although CLWSC provided testimony by two of its attorneys in support of its legal fees, CLWSC offered Mr. Loy as an expert witness to provide testimony on this exact issue. Further, Mr. Loy testified on the reasonableness of attorneys' fees in the *Aqua Texas* case, with both Mr. Terrill and Mr. Zeppa representing *Aqua Texas*.<sup>358</sup>

Like Mr. Loy, Ms. Loockerman is qualified to testify regarding attorneys' fees in this rate case.<sup>359</sup> Ms. Loockerman is a CPA with over 20 years of experience in the area of water and sewer utility regulation. She has worked with attorneys representing both utilities and the ED. She has testified in rate cases about attorneys' fees and has reviewed hundreds of invoices from law firms. She has assisted attorneys in preparing discovery responses and preparing for trial. In this case, she consulted with the ED's attorney, Brian MacLeod, on whether the legal expenses were reasonable, necessary, and in the public interest.<sup>360</sup> Further, contrary to CLWSC's allegations that Ms. Loockerman is unfamiliar with TDRPC rule 1.04(b), she testified that she had read the rule, she had looked at the novelty and difficulty of the legal questions, and had considered the time and labor spent on the issues.<sup>361</sup> The ALJs are convinced that Ms. Loockerman has the experience and competence to testify on whether CLWSC's attorneys' fees are in the public interest.

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<sup>357</sup> CLWSC Ex. C, pp. 67-70.

<sup>358</sup> *In the Application of Aqua Dev. Co.*, SOAH Docket Nos. 582-05-2770 & 582-05-2771, TNRCC Docket Nos. 2004-1671-UCR & 2001-1120-UCR, Final Order Sep. 23, 2008 (PFD, pp. 67 & 68).

<sup>359</sup> CLWSC asserts that in a recent appeal case involving the Lower Colorado River Authority (LCRA), SOAH ALJ Henry D. Card sustained an objection to Ms. Loockerman's testimony by applying the concepts advocated by CLWSC in this case that only attorneys can testify about attorneys' fees. CLWSC RCE Closing, p. 7. However, the transcript shows that ALJ Card excluded Ms. Loockerman's testimony because the ED did not make a timely disclosure about her testimony, and it would be unfair to the other parties. Although a party had objected to Ms. Loockerman's qualifications to testify on attorneys' fees, ALJ Card did not exclude her testimony on that basis. *Appeal of the Retail Water and Wastewater Rates of the LCRA*, SOAH Docket No. 582-08-2863, TCEQ Docket No. 2008-0093-UCR, Tr. p. 1827 (CEWR RCE Reply, App. A).

<sup>360</sup> Tr. pp. 1778-1780.

<sup>361</sup> Tr. p. 1818.

### C. The ED's Requested Rate Case Expense Disallowances

Ms. Loockerman testified on behalf of the ED and recommended that CLWSC's rate case expenses be reduced by \$180,575.65.<sup>362</sup> The ED maintains that it is in the public interest to deduct all of his recommended adjustments from the total of CLWSC's requested rate case expenses of \$971,758.39.

#### 1. Order No. 8

The ALJs provide this brief history to give context to the issuance of Order No. 8. In early 2011, CEWR submitted discovery requests to CLWSC, asking for certain documents in their native form.<sup>363</sup> CEWR filed a motion to compel the documents in their native form, and ALJ Qualtrough granted that request. On April 27, 2011, CLWSC provided their discovery responses in native form. Approximately one month later, on May 20, 2011, CLWSC filed its prefiled testimony, which included amendments to its original application. On May 31, 2011, CEWR filed a motion seeking to strike the amendments, alleging that its expert had spent significant time and resources analyzing inaccurate information produced by CLWSC in discovery in April 2011.

ALJ Qualtrough convened a telephonic prehearing conference on June 8, 2011 to discuss CEWR's motion to strike. At the prehearing conference, counsel for CLWSC explained that the asset lives used in the trending study were different from the assets lives shown on CLWSC's books. Although both methods were acceptable, it was necessary to revise the trending study to provide consistency between the utility's books and the trending study. During the discussions at the June 8, 2011 hearing, it became apparent to the ALJ that CLWSC needed to show that it had good cause to amend its application as required by 30 Tex. Admin. Code § 291.25(g). In

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<sup>362</sup> ED Ex. 8, p. 1.

<sup>363</sup> "Native form" refers to the original electronic format of the document. For example, CEWR had requested certain documents in the native form of a Microsoft Excel spreadsheet file, not the pdf version of the documents.

response, on June 24, 2011, CLWSC filed a motion to amend its rate change application. On July 14, 2011, CEWR and the ED responded filed responses.

After reviewing the parties' motions and responses and the discussion at the prehearing conference, the ALJ issued Order No. 8 on August 2, 2011. The ALJ concluded that CLWSC had failed to meet its obligation to timely supplement its discovery responses as required by the Texas Rules of Civil Procedure (TRCP).<sup>364</sup> According to TRCP rule 193.5(b), if a party learns that its previous response to written discovery was incomplete or incorrect, the party must supplement that response in the same form as the initial response "reasonably promptly" after the party discovers that a response is necessary. Given that CLWSC knew CEWR's expert was analyzing inaccurate information, the ALJ concluded that CLWSC failed to supplement its discovery responses in a reasonably prompt manner.<sup>365</sup>

In the Order, however, the ALJ did not grant CEWR's request to strike the amended application as a discovery sanction because the ALJ could not determine the motivation for the failure to timely supplement.<sup>366</sup> As stated in Order No. 8, it was unclear to the ALJ when CLWSC realized it needed to revise its trending study and whether it knowingly provided inaccurate discovery responses to CEWR.

The evidence admitted during the August 2012 hearing on CLWSC's rate case expenses points to the conclusion that CLWSC knowingly produced inaccurate or soon-to-be-outdated discovery responses to CEWR in April 2011. The billing statements for GDS Associates, Inc., show that in January and February 2011, GDS was in the process of revising the "cost study."<sup>367</sup> So, when CLWSC produced its discovery responses to CEWR in April 2011, it knew that the information was no longer accurate and was being revised. However, it was not until May 20,

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<sup>364</sup> The TCEQ's rules require that discovery in a contested case hearing will be conducted in accordance with the TRCP. 30 Tex. Admin. Code § 80.151.

<sup>365</sup> Order No. 8, p. 5.

<sup>366</sup> Order No. 8, p. 5.

<sup>367</sup> CLWSC Ex. 74, pp. 2251 & 2254. For example, on February 1 and 2, 2011, GDS' employee Maria Elena Eick spent a total of 15.75 hours on "[c]ost study revisions for [Dr. Gebhard] and [Mr. Loy]." CLWSC Ex. 74, p. 2254.

2011, when CLWSC filed its prefiled testimony and its amended application that CEWR became aware that its expert had been reviewing inaccurate information for at least a month. According to CEWR, this essentially nullified the work of its expert. Further, even though CLWSC amended its application on May 20, 2011, it was not until June 4, 2011 that CLWSC finally supplemented its discovery responses.

The ED seeks to adjust CLWSC's requested rate case expenses by \$82,392.03 in expenses associated with Order No. 8.<sup>368</sup> The ED recommends removing \$70,867.03 in CLWSC expenses incurred to comply with Order No. 8, and \$11,525 in expenses incurred by CEWR in reviewing outdated information that CLWSC produced knowing that it was outdated.<sup>369</sup>

The ALJs agree with the ED's proposed reduction of \$70,867.03. The expenses incurred by CLWSC in responding to Order No. 8 were caused by its failure to meet its discovery obligations. Therefore, those expenses are not reasonable or necessary, and are not in the public interest. However, the ALJs do not agree with the ED that CLWSC's rate case expenses should be reduced by an additional adjustment of \$11,525 attributable to CEWR's expenses incurred in analyzing CLWSC's outdated discovery responses. The ALJs are unaware of any statutory or regulatory basis for such a reduction.

CLWSC attempts to characterize Order No. 8 as an unprecedented response to CLWSC's amendment of its application.<sup>370</sup> However, Order No. 8 was remedial in nature in its attempt to repair the damage caused by CLWSC's failure to timely supplement discovery responses. To remedy the waste of CEWR's resources, Order No. 8 stated:

To address CLWSC's failure to timely supplement its discovery responses, CLWSC must identify the changes between its prior application and its revised application, to the extent it has not already done so, in its motion to amend and the

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<sup>368</sup> ED Ex. 8, p. 1. The ALJs have attached the August 2, 2011, Order No. 8 to the PFD.

<sup>369</sup> ED Ex. 8, p. 2.

<sup>370</sup> CLWSC RCE Closing, pp. 15-16; Tr. p. 1691.

attached affidavits. This includes specifying the changes caused by the updates to the Handy-Whitman data and the changes to the service lives of each asset.<sup>371</sup>

In the ALJs' opinion, CLWSC should not be awarded expenses to comply with Order No. 8 because the Order was a response to CLWSC's failure to meet its discovery obligations. Therefore, these expenses were not necessary nor in the public interest. The ALJ did not issue Order No. 8 simply because CLWSC amended its Application; the order was issued to remedy the harm caused by CLWSC's failure to timely supplement its discovery responses. Further, even though CLWSC may have had good cause to amend its application, this good cause does not excuse or justify its failure to timely supplement. Had CLWSC informed CEWR that it was revising its discovery responses, CEWR could have avoided the waste of resources. Therefore, the rate case expenses incurred to comply with Order No. 8 are unreasonable, unnecessary, and not in the public interest. The ALJs agree with the ED's adjustment to reduce CLWSC's rate case expenses by \$70,867.03.

However, the ALJs do not recommend reducing CLWSC's rate case expenses by \$11,525, the cost incurred by CEWR in reviewing erroneous information.<sup>372</sup> Neither the statute nor the rule provides for the reduction of a utility's expenses by the expenses of another party.<sup>373</sup> Therefore, the ALJs conclude that such a reduction is not permissible.

## **2. Deposition and Hearing Transcript Costs**

CLWSC included the transcription costs in its rate case expenses.<sup>374</sup> At the hearing, Ms. Loockerman recommended that the rate case expenses for the transcripts of depositions and the evidentiary hearing evidence should be deducted from CLWSC's rate case expenses and

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<sup>371</sup> Order No. 8, p. 10.

<sup>372</sup> Ms. Loockerman testified that she received the information regarding CEWR's expenses through CEWR's discovery responses. Tr. p. 1793; ED-DL-1, pp. 35-36; ED-DL-41.

<sup>373</sup> Tex. Water Code § 13.185(h); 30 Tex. Admin. Code § 291.28(7).

<sup>374</sup> CLWSC Ex. 73, pp. 3044-3046.

allocated between the parties according to 30 Tex. Admin. Code § 80.23.<sup>375</sup> However, in his replies to the parties' closing arguments on the rate case expense issues, the ED seems to have modified that recommendation. The ED argues that there is some leeway in section 80.23(d) that provides the Commission with flexibility in allocating court costs in rate cases if the transcription costs are included in a utility's allowable expenses. CEWR asserts that the court costs should be included in CLWSC rate case expenses. OPIC recommends that the court costs be removed from CLWSC's rate case expenses and allocated pursuant to chapter 80, title 30 of the Texas Administrative Code.

The ALJs agree with CLWSC and CEWR that the transcript expenses should be included within CLWSC's rate case expenses. Section 80.23(d), title 30 of the Texas Administrative Code allows for transcription costs for an evidentiary hearing to be recovered through a utility's expenses. Therefore, the ALJs do not recommend that the Commission reduce CLWSC's requested rates case expenses by \$11,885.68 for the transcription expense.

### **3. Attorneys' Fees for Closing Arguments**

Ms. Loockerman recommended a reduction of \$16,354.69 in the expense claimed by CLWSC's attorneys for work done on the closing arguments. She testified that, based on her experience and after discussing the issue with Mr. MacLeod, she determined that 120 hours in total was a sufficient amount of time to prepare closing arguments. To arrive at her recommended adjustment, Ms. Loockerman explained that she "came up with a percentage based on what was in Mr. Zeppa[']s, Mr. Terrill[']s and Mr. Kirshbaum's billings in regard to closing arguments, and [she] used their hourly rates and multiplied by the percentage to come up with an amount for the 120 hours."<sup>376</sup> According to Ms. Loockerman, the three CLWSC attorneys billed for a total of 187.25 hours to work on the closing arguments. She then multiplied the amount

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<sup>375</sup> ED Ex. 8.

<sup>376</sup> Tr. p. 1794.

billed for each attorney by 35.9% to calculate the amount of the reduction of \$16,354.69.<sup>377</sup> CEWR and OPIC agree with the ED's recommendation.

CLWSC disagrees with the ED's recommended adjustment on the basis that Ms. Loockerman is not qualified to provide testimony about attorneys' fees. CLWSC also argues that Ms. Loockerman failed to follow the "required methodology" found in TDRPC rule 1.04(b).<sup>378</sup> However, CLWSC does not attack the calculations Ms. Loockerman used to arrive at the amount of the ED's recommended adjustment.

The ALJs agree with the ED that CLWSC's legal expenses for preparing the closing arguments should be reduced to 120 hours. CLWSC's own counsel estimated that he could complete the closing arguments in approximately 80 hours.<sup>379</sup> Therefore, it seems that the ED's allowance of 120 hours is generous in light of CLWSC's estimation of 80 hours, and the ALJs agree with the ED's adjustment.

#### **4. Consultant Expenses for Closing Arguments**

The ED recommends a \$9,067.50 reduction in the expenses attributable to CLWSC's consultants' work on the closing arguments. Ms. Loockerman testified that based on her experience, 40 hours for CLWSC's consultants would be appropriate to work on the closing arguments. The ED asserts that to allow recovery of more consultant expenses would not be in the public interest. CEWR and OPIC support this adjustment.

CLWSC claims that this is a complex case and not like any other case in Ms. Loockerman's experience. Further, CLWSC argues that its consultants had to review the revised schedules the ED and CEWR attached to their respective closing arguments.

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<sup>377</sup> ED Ex. 8, p. 2 (percent reduction calculation  $(187.25 - 120) \div 187.25 = 35.9\%$ ).

<sup>378</sup> CLWSC RCE Closing, p. 14.

<sup>379</sup> Tr. pp. 1639-1640. Mr. Zeppa compared the writing of the closing arguments in this case to the writing of the PFD. He estimated that he could write the PFD in this case in approximately two weeks, by working 8:00 a.m. to 5:00 p.m. without interruption.

The ALJs agree with the ED's recommended reduction in consultant expenses for CLWSC's closing arguments. Ms. Loockerman based her recommendation on what she had done in past cases and what the CLWSC's consultants had done previously in this case. She also reviewed the consultants' invoices in making her recommendation.<sup>380</sup> She concluded that 40 hours was sufficient time for CLWSC's consultants to work on the closing arguments, and the ALJs agree with the ED's adjustment. CLWSC's consultants had already prepared their prefiled testimony and reviewed the testimony of the other parties. Further, although the ED and CEWR attached additional schedules to their closing arguments, CLWSC included very little substantive analysis of those schedules in its response.<sup>381</sup> The ALJs conclude that CLWSC's consultant expenses beyond 40 hours are not reasonable and necessary and are not in the public interest. Therefore, the ALJs recommend that the Commission reduce CLWSC's rate case expenses by \$9,067.50.

## **5. Rate of Return Expert Expenses**

The ED recommended that CLWSC's requested expenses in the amount \$55,213.75 for work attributable to Mr. Scheig be reduced by \$45,213.75. Ms. Loockerman testified that the invoices from Mr. Scheig's firm, ValueScope, Inc., do not contain enough detail to determine whether the expenses for his services are reasonable, necessary, and in the public interest. The ED recommended that 40 hours would be a reasonable amount of time for Mr. Scheig to participate in this proceeding, and recommended that \$10,000 in expenses would be reasonable. CEWR and OPIC agree with the ED's recommended reduction.

CLWSC claims the ED's recommendation is simply an arbitrary adjustment. CLWSC asserts that "Mr. Scheig presented invoices and explained all the work he did in this case under cross-examination."<sup>382</sup>

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<sup>380</sup> Tr. p. 1866.

<sup>381</sup> CLWSC Response, pp. 2-3.

<sup>382</sup> CLWSC RCE Response, p. 14.

The ALJs agree with the ED that \$45,213.75 of the requested \$55,213.75 in expenses attributable to Mr. Scheig should be deducted from CLWSC's rate case expenses because CLWSC has failed to meet its burden of proof on this expense. CLWSC overstates the level of detail in ValueScope's invoices and in Mr. Scheig's testimony. Twelve out of fourteen ValueScope invoices describe Mr. Scheig's work as "valuation services" with no other description given.<sup>383</sup> Contrary to CLWSC's assertions, Mr. Scheig's testimony does not provide the missing details because, in some instances, he was unable to testify as to the services he performed. For example, Mr. Scheig testified that for "valuation services" shown on the August 8, 2011 invoice, he performed "four hours of time doing something," but he could not recall what services he was performing.<sup>384</sup>

In addition, some of Mr. Scheig's testimony is erroneous. He testified that the "valuation services" he performed in July and August of 2011 were for the review of the other parties' prefiled testimony.<sup>385</sup> However, CEWR's prefiled its testimony on October 31, 2011, and the ED prefiled his testimony on January 17, 2012. Therefore, Mr. Scheig was mistaken that he reviewed these parties' prefiled testimony in July and August 2011, as he testified.

The ALJs conclude that CLWSC has not met its burden of proof that the majority of the rate case expenses incurred for Mr. Scheig's services were reasonable and necessary and in the public interest. Mr. Scheig's testimony and the ValueScope invoices are devoid of sufficient details needed to make such a determination.<sup>386</sup> Further, the ALJs find that Mr. Scheig's testimony regarding his services is not credible based on his inability to recall needed details and his erroneous testimony. Therefore, the ALJs give little weight to his testimony in this analysis.

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<sup>383</sup> CLWSC Ex. 75.

<sup>384</sup> Tr. pp. 1670-1671.

<sup>385</sup> Tr. p. 1658.

<sup>386</sup> Mr. Scheig seemed to concede that a person could not determine whether the work he performed was reasonable and necessary since there are no details in his invoices. Tr. p. 1665 (Q: With this amount of detail, how can the other parties analyze whether or not any of the work was reasonable or necessary? A: I'm not sure how to answer that question, sir.).

The ALJs conclude that CLWSC has failed to meet its burden of proof that the majority of Mr. Scheig's expenses were reasonable, necessary, and in the public interest.

In the ALJs' opinion, the ED is justified in only recommending \$10,000 in rate case expenses for Mr. Scheig's services, given the lack of evidentiary support for ValueScope expenses. Because the public has an interest in the financial integrity of the utility, the ALJs find the ED's recommendation to allow CLWSC to recover \$10,000 in rate case expenses to be a reasonable one.

The ALJs also have other recommendations regarding Mr. Scheig's invoices. Included in every ValueScope invoice is a "research and administrative fee" that represents either a five or seven percent fee intended to recover ValueScope's subscription costs for its databases. ValueScope charges this fee to all its customers as a percentage of the customers' monthly bills. ValueScope would charge the fee even if it did not access a database on behalf of a customer during any particular month.<sup>387</sup>

The ALJs find that this expense is not reasonable or necessary, and is not in the public interest. This fee bears no relation to the work done on behalf of CLWSC. It is a method ValueScope uses to recover its subscription fees based on the amount of a customer's monthly bill. Given the lack of detail, there is no evidence that during each month the fee was charged to CLWSC, Mr. Scheig accessed ValueScope's databases on behalf of CLWSC in any way proportional to the fee assessed. Although such a fee may be charged by ValueScope to its customers, CLWSC has failed to prove that the fee was reasonable and necessary to CLWSC's rate case. Therefore, the ALJs recommend that CLWSC not recover this overhead fee in its rate case expenses.

In addition, Mr. Scheig apparently paid \$414.61 for "team lunches" for the consultants and legal staff during the hearing.<sup>388</sup> The ALJs conclude that team lunches are not reasonable

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<sup>387</sup> Tr. p. 1656.

<sup>388</sup> CLWSC Ex. 75, p. 3074.

and necessary rate case expenses that are in the public interest and recommend that the Commission exclude these fees from CLWSC's rate case expenses.

ValueScope also charged CLWSC for two trips to Austin, Texas on March 22, 2012, and March 26, 2012.<sup>389</sup> On March 22, 2012, Mr. Scheig first travelled to Austin for hearing preparations. Four days later, on March 26, 2012, Mr. Scheig made a second trip for the actual evidentiary hearing. As a result of these two trips, ValueScope charged CLWSC \$531.83 for the first trip<sup>390</sup> and \$2,104.79 for the second.<sup>391</sup>

It was unnecessary for Mr. Scheig to travel to Austin twice in such a short period of time, and it is not in the public interest to pass those expenses onto CLWSC's customers. Therefore, the ALJs conclude that the charges for the March 22, 2012, travel to Austin are unreasonable, unnecessary, and not in the public interest, and \$531.83 should be deducted from CLWSC's rate case expenses.

Furthermore, ValueScope charged CLWSC \$1,099.40 for four nights in an Austin hotel during the hearing on the merits. This equates to \$275.00 per night. The ALJs agree with the ED that this amount is excessive, and this rate case expense is unreasonable, unnecessary, and not in the public interest, and should be excluded from CLWSC's rate case expenses.

## **6. Attorneys at Depositions and the Hearing**

The ED asserted that CLWSC did not need two attorneys to attend the depositions. Ms. Loockerman recommended an adjustment of \$4,525 to CLWSC's rate case expenses for an

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<sup>389</sup> CLWSC Ex. 75, p. 3074.

<sup>390</sup> CLWSC Ex. 75, p. 3074. The charges for travelling to Austin on March 22, 2012, included \$381.60 for airfare, \$86.09 for car rental and gas, \$8.61 for airport parking, and \$30.53 for transportation to and from the airport. These expenses total \$506.83, not \$531.83 as shown on the invoice.

<sup>391</sup> CLWSC Ex. 75, p. 3074. The charges for the travel to Austin from March 26 through March 30, 2012, included mileage of \$260.85, hotel fees of \$1,099.40, hotel parking of \$77.96, internet usage of \$66.90, three team lunches of \$414.61, and meals of \$185.07, all totaling to the amount shown on the invoice, \$2,104.79.

extra attorney to attend the deposition,<sup>392</sup> but she did not make a reduction for the time the attorneys prepared for the depositions.<sup>393</sup>

Ms. Loockerman also testified that it was not necessary for CLWSC to have three attorneys attend the evidentiary hearing. She recommended a reduction of \$11,137 to CLWSC's rate case expenses, which represents Mr. Kirshbaum's attendance during the hearing.<sup>394</sup> CEWR and OPIC agree with the ED's recommendations on excess attorneys.

Regarding the reduction for excess attorneys at the depositions, CLWSC criticizes the ED's position based on Ms. Loockerman's alleged lack of expertise to testify on such issues. CLWSC also points out that Mr. Kirshbaum's services were necessary because he assisted with trial preparation, presented Mr. Scheig's testimony, and performed much of the work for the closing arguments.

The ALJs disagree with the ED's recommended reduction for excess attorneys. Because this was a very complex case, the ALJs will not second guess attorney strategy or preparation. All of CLWSC's attorneys performed a function at the hearing and in preparation of the case. Therefore, the ALJs decline to recommend that the Commission reduce CLWSC's rate case expenses for allegedly excessive attorney time.

## **7. Estimates for Rate Case Expense Hearing**

CLWSC requests the following estimates for the August 22 and 23, 2012 evidentiary hearing be included in its rate case expenses:

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<sup>392</sup> ED Ex. 8, p. 2.

<sup>393</sup> Tr. p. 1797.

<sup>394</sup> ED Ex. 8, p. 2.

Attorney	Rate/Time	Amount
Mr. Terrill	\$375 per hour for 28 hours	\$10,500 <sup>395</sup>
Mr. Kirshbaum	\$225 per hour for 15 hours	3,375 <sup>396</sup>
<b>Total Rate Case Expenses for Hearing</b>		<b>\$13,875</b>

Mr. Zeppa estimated that for July 2012, he had generated \$2,500 in attorneys' fees,<sup>397</sup> but he did not provide an estimate for the August 2012 evidentiary hearing. From the record, it does not appear that CLWSC estimated expenses for its consultants' participation in the August 2012 evidentiary hearing.<sup>398</sup>

The ED recommends that CLWSC recover \$20,875 in estimated rate case hearing expenses. This includes estimates for Mr. Terrill, Mr. Zeppa, and Mr. Loy.

The ALJs recommend a finding that CLWSC's estimated rate case expenses of \$16,375 incurred to participate in the August 22 and 23, 2012 evidentiary hearing are reasonable, necessary, and in the public interest. This includes Mr. Zeppa's attorneys' fees for July 2012.

## 8. Exceptions and Agenda

At the hearing, CLWSC presented the following estimates for its post-hearing exceptions:<sup>399</sup>

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<sup>395</sup> Tr. pp. 1526-1527.

<sup>396</sup> Tr. pp. 1526-1527.

<sup>397</sup> Tr. p. 1585. This estimate is only for July 2011. Mr. Zeppa did not provide an estimate for his fees for August 2012.

<sup>398</sup> See CLWSC RCE Closing, p. 13. CLWSC indicates that only the expenses for The Terrill Firm, P.C. and the Law Offices of Mark Zeppa, P.C. include estimated rate case expenses.

<sup>399</sup> Tr. pp. 1527-1529.

Item	Amount
Rate Case Expenses through Agenda (Favorable PFD)	\$25,000
Rate Case Expenses through Agenda (Unfavorable PFD)	\$50,000
Appeal to Travis County District Court	\$50,000
Appeal to Third Court of Appeals	\$50,000
Appeal to Texas Supreme Court	\$50,000

According to Mr. Terrill, CLWSC will have to expend substantially more in legal fees to respond to an unfavorable PFD as opposed to a favorable PFD.

The ED argues that for exceptions and agenda, CLWSC's estimated expenses should be \$22,500. Ms. Loockerman testified that this represents 60 hours billed at \$350, the highest billing rate for CLWSC's attorneys.<sup>400</sup> Regarding the issue of the favorability of a PFD, the ED asserts that the PFD's recommendations should not make a difference in the amount of the legal fees. If a PFD is favorable to a party, that party will be spend less time on exceptions to the PFD but will spend more time responding to the other parties' exceptions. Conversely, if a PFD is unfavorable to a party's position, the party will spend more time filing exceptions to the PFD than he will spend responding to the other parties' exceptions. Therefore, the ED asserts that \$22,500 is sufficient for post-hearing briefings and agenda, regardless of the recommendation contained in the PFD.

OPIC and CEWR object to an upward adjustment in CLWSC's rate case expenses for estimated, post-hearing expenses. According to CEWR, CLWSC has the burden of proof on this issue and should not be awarded estimated rate case expenses. OPIC asserts that if CLWSC considers the PFD to be unfavorable, the rate case expenses would then be doubled and passed on to its customers.

The ALJs agree with the ED and recommend that \$22,500 in anticipated attorneys' fees is reasonable and necessary and in the public interest. The parties have fully briefed the legal and factual issues in this case in preparing their closing arguments and responses. Therefore, any

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<sup>400</sup> Tr. pp. 1798-1799.

exceptions and responses will be a restatement of the parties' positions previously expressed in the briefing in this case.

Further, the ALJs do not recommend that CLWSC be allowed to recover its estimated expenses for appeal of any Commission decision. Such an estimation is too speculative and the ALJs cannot make a determination that the estimated rate case expenses are reasonable and necessary and in the public interest.

#### **9. CLWSC's Objections to Prefiled Testimony**

In his closing arguments, the ED asserts that \$5,545 should be deducted from CLWSC's legal expenses because of CLWSC's allegedly unnecessary objections to the prefiled testimony. The ED argues that voluminous and inappropriate objections may help a party win a case by draining its opponents' resources, but it is not in the public interest to pass on those expenses to a utility's customers.<sup>401</sup> CLWSC responds that this recommended adjustment is outside the record, and it has not had an opportunity to cross-examine Ms. Loockerman on this issue.

The ALJs disagree with the ED's recommendation. It is necessary for a party to object to testimony in order to preserve error. Although the ALJs overruled all of CLWSC's objections, the ALJs do not find that CLWSC abused the process.

#### **D. CEWR's Requested Disallowances**

##### **1. Redundant Trending Study Costs**

CEWR claims that CLWSC may have "double-dipped" regarding the costs for the trending study. Although CLWSC claimed \$150,000 in its rate base, a review of GDS' invoices shows expenses incurred for work on the "cost study." Since CEWR cannot determine whether

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<sup>401</sup> ED RCE Closing, p. 25.

duplicate charges for work done on the trending study can be found in CLWSC's proposed rates and its rate case expenses, CEWR recommends that \$150,000 be deducted from CLWSC's rate case expenses. In response, CLWSC claims that (1) the trending study expenses were already considered during the hearing on the merits; (2) the trending study costs are not included in any amount for rate case expenses; and (3) CEWR's double-dipping assertions were controverted by Mr. Loy's testimony.

A review of Mr. Loy's testimony indicates that the \$150,000 for the trending study was billed by Dr. Gebhard under a different project number.<sup>402</sup> Further any expenses for the development of the trending study were incurred prior to the filing of the Application because CLWSC used the trending study to support its rate base valuation. CLWSC proposed to recover the costs for the trending study in its rate base and to recover the costs of "advocating" for the use of the trending study in its rate case expenses.<sup>403</sup> Based on this testimony, the ALJs do not find that CLWSC requested a double recovery of expenses for the trending study, and the ALJs do not recommend a \$150,000 deduction from CLWSC's rate case expenses.

## **2. Ms. Eick's Travel Expenses**

Mary Elena Eick is a GDS employee. On July 8, 2010, GDS billed CLWSC for \$595 for Ms. Eick's travel expenses incurred during June 2010.<sup>404</sup> However, GDS did not bill CLWSC for any time Ms. Eick spent working on this application during this same time period.

For billing purposes, GDS maintains two project numbers for CLWSC: one project number for the trending study, and one project number for CLWSC's rate case expenses. Mr. Loy testified that Ms. Eick allocated her travel time to the two project numbers in proportion to the amount of time she billed working on the two projects.<sup>405</sup> However, she did not bill time

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<sup>402</sup> Tr. p. 1697.

<sup>403</sup> Tr. p. 1689.

<sup>404</sup> CLWSC Ex. 74, p. 2214.

<sup>405</sup> Tr. p. 1708.

to CLWSC rate case expenses for June 2010. Since she did not bill time to CLWSC's rate case expenses, the ALJs are unable to determine whether Ms. Eick's travel expenses were properly allocated to this project number.

The ALJs agree with CEWR that CLWSC's rate case expenses should be reduced by \$595. The record does not demonstrate that Ms. Eick worked on this project during June 2010. Therefore, it cannot be determined whether the \$595 in travel expenses was properly allocated, and CLWSC has not met its burden of proof that this travel expense was reasonable, necessary, and in the public interest.

### **3. Rate Base Expenses**

CEWR asserts that over 50% of CLWSC's rate case expenses were incurred as a result of its use of the trending study. According to CEWR, CLWSC was attempting to overstate the original cost of its pre-acquisition assets through the use of a trending study. Therefore, CEWR maintains that if the Commission agrees with either the ED or CEWR on the rate base issue, then those rate case expenses attributable to the trending study are not reasonable or necessary, or in the public interest. CLWSC responds that CEWR's adjustment is arbitrary and capricious, and under this theory, CLWSC's rate case expenses should be enhanced by 50% because of CEWR's attempts to undervalue CLWSC's original cost.<sup>406</sup>

The ALJs do not agree with CEWR's adjustment. Although CLWSC did not convince the ALJs of the reliability of the trending study, it is reasonable for CLWSC to recover its rate case expenses associated with the trending study. These expenses were documented in the GDS invoices, and the ALJs do not recommend such a reduction.

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<sup>406</sup> CLWSC RCE Response, p. 20.

#### **4. Parking Expense**

CEWR argues that an \$8 parking expense should be deducted from CLWSC's rate case expenses because this is a charge Mr. Hodge incurred while visiting the state capitol to testify at a legislative hearing on March 22, 2011.<sup>407</sup> The receipt indicates that Mr. Hodge parked at the Capitol Visitors Parking Garage, but CEWR points out that none of CLWSC's attorneys or consultants performed work for CLWSC on that date. Furthermore, a witness list for the March 22, 2011 meeting of the Natural Resources Committee indicates that Mr. Hodge was a testifying witness against HB 206.<sup>408</sup>

CLWSC responds without elaboration that CEWR's adjustment is a mischaracterization of the record. However, the only evidence in the record demonstrates that this expense was for legislative advocacy, and was not a reasonable and necessary rate case expense. The ALJs concur with CEWR that this \$8 expense should be deducted from CLWSC's rate case expenses.<sup>409</sup>

#### **E. Erroneous GDS charge**

Mr. Loy testified that \$270 was incorrectly billed to the CLWSC account.<sup>410</sup> The ALJs recommend that the charge of \$270 be removed from CLWSC's rate case expenses.

#### **F. Summary of the ALJ's Recommended Adjustments**

The ALJs recommend that CLWSC recover \$856,742.42 in rate case expenses. This is the amount the ALJs have determined is reasonable, necessary, and in the public interest. Below

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<sup>407</sup> CLWSC Ex. 76, p. 2584.

<sup>408</sup> CEWR Ex. 51.

<sup>409</sup> Tex. Water Code § 13.185(h)(1).

<sup>410</sup> Tr. p. 1684; CLWSC Ex. 74, p. 2204.

is a summary of the ALJs’ recommendations regarding CLWSC’s requested rate case expenses and the recommended adjustments.

Item	Amount
CLWSC’s Claimed Rate Case Expenses	\$971,758.39 <sup>411</sup>
Reduction – Order No. 8 Adjustments	< 82,392.03>
Reduction – Attorneys’ Fees for Closing Arguments	< 16,354.69>
Reduction – Consultant Fees – Closing Arguments	< 9,067.50>
Reduction – Rate of Return Expert	< 45,213.75>
Increase – Estimate for Rate Case Expense Hearing	16,375.00
Increase – Estimate for Exceptions and Agenda	22,500.00
Reduction – Ms. Eick’s Travel Expenses	< 585.00>
Reduction – Parking at Capitol Visitor Center	< 8.00>
Reduction – GDS charge not attributable to CLWSC	< 270.00>
<b>Total Rate Case Expenses</b>	<b>\$856,742.42</b>

**G. CLWSC’s Ability to Recover Rate Case Expenses**

According to the TCEQ’s rules, a utility may not recover rate case expenses from its customers if it does not meet specified thresholds. These thresholds are found in 30 Tex. Admin. Code § 291.28 and are referred to as the “51% Rule”<sup>412</sup> and the “Settlement Rule.”<sup>413</sup>

Since the ALJs have made recommendations in this PFD that alter the revenue requirement, the ALJs do not have sufficient information to make a recommendation on whether CLWSC has met the thresholds found in section 291.28(8) and (9). However, the ALJs can review the evidence and make recommendations regarding the interpretation of the 51% Rule and the Settlement Rule.

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<sup>411</sup> CLWSC Ex. 78.

<sup>412</sup> 30 Tex. Admin. Code § 291.28(8).

<sup>413</sup> 30 Tex. Admin. Code § 291.28(9).

### 1. Fifty-One Percent Rule

The TCEQ's 51% Rule provides that "[a] utility may not recover any rate case expenses if the increase in revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility's proposed rate."<sup>414</sup> The parties differ as to what revenues should be included to make a determination under this rule.

As an initial matter, CLWSC argues that, in addition to the revenue generated by its proposed rates, revenue from the rate case expense surcharge should also be included in the determination of revenue generated by the new rates. CLWSC maintains that section 291.28(8) "does not specify which just and reasonable rates should be considered."<sup>415</sup>

The ALJs disagree with CLWSC's interpretation of section 291.28(8). As stated by the ED, including the rate case expenses would undermine the purpose of the 51% Rule and skew the calculation for the utility's benefit. The TCEQ adopted section 291.28(8) to discourage utilities from filing applications with an inflated revenue requirement. When amending section 291.28(8) in 2006, the TCEQ stated:

Utility customers have expressed concern over the possibility that utilities may have an incentive to overreach in their rate applications if utilities believe that the customers ultimately will bear all rate case expenses. The purpose of this rule change is to set out clearly certain instances when, as a matter of law, rate case expenses will be considered unreasonable, unnecessary, and against the public interest.<sup>416</sup>

The ALJs conclude that rate case expenses recommended in this PFD are not "generated by a utility's proposed rate" as required by 30 Tex. Admin. Code § 291.28(8). CLWSC's

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<sup>414</sup> 30 Tex. Admin. Code § 291.28(8).

<sup>415</sup> CLWSC RCE Closing, p. 17.

<sup>416</sup> 31 Tex. Reg. 8106, 8107 (Sep. 22, 2006).

“proposed rates” are those rates included in its “Notice of Proposed Rate Change.”<sup>417</sup> Furthermore, as stated by the TCEQ, the purpose of the 51% Rule is to determine if the rate case expenses are unreasonable, unnecessary, and against the public interest. Therefore, the ALJs cannot include the rate case expenses within the very calculation used to determine whether those expenses are in fact reasonable, necessary, and in the public interest. The ALJs recommend that the rate case expenses not be considered as revenues generated by the new rates pursuant to the calculations required by the 51% Rule.

The ED provided the following formula to be used in making the 51% Rule calculations,<sup>418</sup> and the ALJs have left blank those values that will result from the resolution of this rate case:

Revenues Generated from New Rates	(A) _____	
Revenues Generated by Previous rates	-- (B) \$6,917,243	
Increase in Revenue Generated	(C) _____	((A) – (B) = (C))
Revenues Generated by Proposed Rates	(D) \$11,568,442	
Revenues Generate by Previous Rates	-- (B) \$ 6,917,199	
Difference	(E) \$ 4,651,199	((D) – (B) = (E))

CLWSC disputes the ED’s amount of \$6,917,243 as the correct revenue generated by its previous rates, represented as (B).<sup>419</sup> However, CLWSC does not explain why \$6,917,243 is an incorrect value for (B).<sup>420</sup> Therefore, the ALJs conclude that the formula and amounts recommended by the ED are correct. Fifty-one percent of the proposed increase in revenue is \$2,372,111. The ALJs request that the ED complete the calculation in his exceptions based on the recommendations made in this PFD to determine if CLWSC has met this threshold.

<sup>417</sup> CLWSC Ex. 1, pp. 33-39.

<sup>418</sup> ED Ex. 9.

<sup>419</sup> CLWSC RCE Closing, p. 17.

<sup>420</sup> The ED derived his revenue figures from CLWSC Ex. 1, p. 100. The ED added together CLWSC’s “metered revenue residential” of \$6,899,243 and “unbilled revenue” of \$18,000, for a total “revenues generated by [CLWSC’s] previous rates” of \$6,917,243.

## 2. Settlement Rule

The TCEQ's Settlement Rule provides:

A utility may not recover any rate case expenses incurred after the date of a written settlement offer by all ratepayer parties if the revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than or equal to the revenue that would have been generated by the rate contained in the written settlement offer.<sup>421</sup>

On July 21, 2011, CEWR sent a settlement offer to CLWSC.<sup>422</sup> CEWR offered to settle this proceeding if, *inter alia*, CLWSC agreed to a 20% increase in its revenue requirement and a net book value that resulted in invested capital of \$25.6 million.

CLWSC claims that this settlement offer is incomplete and cannot be used to compare to the rates determined in this proceeding. However, section 291.28(9) directs the ALJs to examine "the revenue generated by the just and reasonable rate . . . ." CEWR offered a 20% increase in the revenue requirement. As shown by the ED, an increase in revenue can be calculated by increasing the revenue requirement by 20%.<sup>423</sup> Therefore, the ALJs conclude that the July 21, 2011 settlement offer is sufficient to determine the applicability of 30 Tex. Admin. Code § 291.28(9).

According to the ED's calculations, CEWR's settlement offer would have generated \$8,300,692 in total annual revenue.<sup>424</sup> If the revenue requirement ultimately approved in this case is less than \$8,300,692, then the Settlement Rule would apply, and CLWSC could not recover from its customers those rate case expenses incurred after July 21, 2011.

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<sup>421</sup> 30 Tex. Admin. Code § 291.28(9).

<sup>422</sup> CEWR Ex. 52.

<sup>423</sup> Tr. pp. 1806-1807.

<sup>424</sup> ED Ex. 9. To determine how much revenue would be generated by an increase of 20% in the revenue requirement, the ED multiplied \$6,917,243, the annual revenue generated by CLWSC's previous rates, by 1.20 ( $\$6,917,243 \times 1.20 = \$8,300,392$ ).

### 3. Surcharge Recommendation

The ED recommends that CLWSC recover its rate case expenses through a 24-month surcharge, as follows:

CLWSC should be ordered to cease billing the surcharge at the earliest of the following dates: the billing cycle in which the full amount has been billed to the customers, or the billing cycle in which the full amount has been collected.

CLWSC should be ordered to file a report every six months to the Utilities Financial Review Section of the TCEQ including the total amount of surcharge billed, the total amount of surcharge collected, and any related bad debt write offs. This report should continue until billing ceases, with the final report reconciling to the amount of the rate case expenses allowed in this case.<sup>425</sup>

The ED recommended a rate surcharge of \$3.83 per connection per month if the 51% rule is exceeded.

CLWSC generally agreed with the ED's calculation, but stated that full collection, not billing, should be the cut-off point recovering the surcharge. OPIC and CEWR did not take a position regarding the ED's proposed surcharge.

The ALJs agree with the ED's recommendation. The ALJs request that the ED recalculate the surcharge based on the ALJs' recommendations regarding rate case expenses.

## XII. CONCLUSION

CLWSC's proposed rates, as reflected in the Rate/Tariff Change Application filed with the TCEQ on August 27, 2010, are reasonable and necessary to provide water to its ratepayers, with modifications as set out in this PFD. Further, CLWSC has proved that it should recover \$856,742.42 in rate case expenses, assuming it meets the thresholds in 30 Tex. Admin. Code § 291.28(8) and (9).

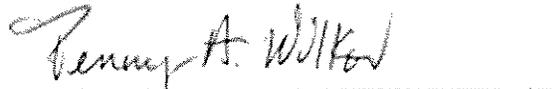
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<sup>425</sup> ED Ex. 8, p. 1.

The ALJs have attached a draft Proposed Order, which they will revise to reflect the calculations based on the ALJs' specific recommendations that the ED will provide in his exceptions. The ALJs further recommend that the Commission deny any proposed findings of fact submitted by the parties inconsistent with the recommendations in this PFD.

**SIGNED December 3, 2012.**

  
KERRIE JO QUALTROUGH  
ADMINISTRATIVE LAW JUDGE  
STATE OFFICE OF ADMINISTRATIVE HEARINGS

  
PENNY A. WILKOV  
ADMINISTRATIVE LAW JUDGE  
STATE OFFICE OF ADMINISTRATIVE HEARINGS

**ATTACHMENT A**

**SOAH DOCKET NO. 582-11-1468  
TCEQ DOCKET NO. 2010-1841-UCR**

**APPLICATION OF SJWTX, INC. DBA § BEFORE THE STATE OFFICE  
CANYON LAKE WATER SERVICE §  
COMPANY TO CHANGE WATER § OF  
RATES; CCN NO. 10692; IN COMAL §  
AND BLANCO COUNTIES § ADMINISTRATIVE HEARINGS**

**ORDER NO. 8  
RULING ON MOTION TO STRIKE AND  
MOTION TO AMEND RATE CHANGE APPLICATION**

On May 20, 2011, SJWTX, Inc. dba Canyon Lake Water Service Company (CLWSC) filed its prefiled testimony in this case and amended its original application. On May 31, the Coalition for Equitable Water Rates (CEWR) filed a motion to strike the amendments stating that because of CLWSC's abuse of discovery, its expert spent significant time and resources analyzing information that was no longer accurate. The Administrative Law Judge (ALJ) convened a prehearing conference to discuss the issues. During the hearing, it became apparent that CLWSC would need to show that it had good cause to amend its application pursuant to 30 TAC § 291.25(g). On June 24, CLWSC filed a motion to amend its rate change application. On July 14, CEWR filed a reply and the Executive Director (ED) responded on July 15. The ALJ has reviewed the parties' submissions and determined that although CLWSC failed to timely supplement its discovery responses, there is good cause to amend its rate change application.

In its motion to amend, CLWSC first argues that CEWR's complaint goes to the timeliness of CLWSC's discovery responses. Then, CLWSC addresses the issue of whether there is good cause to amend its rate application. The ALJ will first discuss the issue of whether CLWSC properly supplemented its discovery responses, and then explain her ruling on its request to amend its application.

**1. Timeliness of CLWSC's Discovery Responses**

**a. CLWSC's Position**

CLWSC asserts that the real issue in CEWR's complaint is whether CLWSC's discovery responses were timely. CLWSC argues that CEWR received answers to discovery requests in the form and fashion required by the Texas Rules of Civil Procedure and the pretrial orders entered in this docket. CLWSC further asserts that the information requested by CEWR does not exist. Although CEWR demanded production of spreadsheets in a "native form," no new spreadsheets were prepared by CLWSC's consultants as there is no new Attachment 5 in a spreadsheet format. CLWSC claims that it is under no obligation to create new documents in whatever format CEWR wants.

CLWSC explains that during discovery and while preparing prefiled testimony, its consultants and attorneys learned that information previously provided was incomplete or incorrect. CLWSC recognizes that it had an affirmative duty to provide the new information and correct the incorrect information within a reasonable period of discovering the problems. CLWSC claims it performed this duty by providing the new information and explanations in its prefiled testimony, and sending the additional discovery answers to CEWR. Since there are no pretrial orders setting deadlines on supplementation of discovery, CLWSC argues that its efforts to apprise all parties of changed information were timely as they occurred several months before the scheduled hearing date.

**b. CEWR's Position**

CEWR argues CLWSC is trying to obfuscate its request for amendments to its application by suggesting the current issues in the docket are the result of a discovery dispute with CEWR. However, CEWR contends that the issues presented here represent far more than a failure of CLWSC to timely provide discovery responses.

CEWR explained in its motion to strike that CLSWC has not been prompt in producing documents CEWR considered to be critical to this case. CEWR asserts that after it received a ruling to produce native files, CLWSC took an additional 13 days from the date of filing its prefiled testimony to produce a native file, even though CEWR's prefiled testimony was due on June 17 by agreement. CEWR stated that this file should have been available on May 20, the date CLWSC filed its prefiled testimony, if not sooner. According to CEWR, it reminded CLWSC of the need to supplement promptly after CLWSC prefiled its direct case. CEWR claims that CLWSC's resistance to discovery is troubling and worthy of sanctions.

CEWR claims that virtually all of its consultant's work to date has been nullified by the myriad of changes made by CLWSC in updating indices and changing asset lives. CEWR re-urges the relief specified in its motion to strike for CLWSC's alleged discovery abuse. CEWR requests that CLWSC pay a penalty to CEWR in the amount of the costs CEWR spent reviewing outdated information and seeking relief. Finally, CEWR requests that CLWSC be required to identify the changes between its prior application and its revised application.

**c. ALJ's Analysis**

The ALJ concludes that CLWSC has not timely supplemented its discovery responses. The burden to supplement is on the party responding to written discovery.<sup>1</sup> If a party learns that its previous response to written discovery was incomplete or incorrect, the party must supplement that response in the same form as the initial response "reasonably promptly" after the party discovers that a response is necessary.<sup>2</sup>

CLWSC states that it discovered the incorrect data during the discovery process and the preparation of prefiled testimony. However, CLWSC does not elaborate on when that discovery was actually made. Therefore, the ALJ is unable to determine whether CLWSC was reasonably prompt in supplementing its responses. Further, in the ALJ's opinion, the length of time a party

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<sup>1</sup> Tex. R. Civ. P. 193.5(a).

<sup>2</sup> *Id.* 193.5(b).

knows another party may be analyzing inaccurate information goes to the reasonableness of the timing of the supplementation.

CLWSC argues it supplemented its initial discovery responses more than 30 days before the hearing; therefore, it was reasonably prompt in providing its supplementation under TEX. R. CIV. P. 193.5(b), which states that supplementation is presumed untimely if it occurs less than 30 days before trial. However, it is not presumed that supplemental responses made more than 30 days before trial are reasonably prompt. If the opposite presumption had been intended, it would have been included in the language of the rule.<sup>3</sup>

Also, reliance on the Texas Rules of Civil Procedure is difficult when prefiled testimony is used for the parties' direct cases. As stated by CLWSC, prefiled testimony sets out the experts' opinions. If responses are not reasonably supplemented before the prefiled testimony is due, the expert cannot evaluate and express their opinions regarding the strengths and weaknesses of the other party's case. CEWR states that even though CLWSC prefiled its testimony on May 20, it waited an additional 13 days to produce the native file which should have been available on May 20, if not sooner. Therefore, this production was only 15 days before CEWR's prefiled testimony was due on June 17. CLWSC was not reasonably prompt in supplementing its initial discovery responses.

Further, a supplemental response must be in the same form as the initial response. It is not apparent to the ALJ that CLWSC's prefiled testimony meets this requirement. For example, Dr. Gebhard stated that the change in the Handy-Whitman data affects the computations of a large number of items. The prefiled testimony may not be at the level of detail to adequately show which initial responses have been changed by the change to the Handy-Whitman data. CLWSC gives no citation to its prefiled testimony to demonstrate how its initial responses were clarified. The ALJ is not persuaded by CLWSC's argument that its prefiled testimony is sufficient to satisfy its duty to supplement its changed or inaccurate initial discovery responses.

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<sup>3</sup> *Navarrete v. Williams*, 2011 Tex. App. LEXIS 1876 (Tex. App.--El Paso, Mar. 16, 2011, no pet. h.).

Therefore, the ALJ concludes that CLWSC failed to timely supplement its initial discovery responses. However, the ALJ disagrees with CEWR's assertion that this failure rises to the level of a resistance to discovery or an abuse of discovery sufficient to warrant the striking of the amendments. CLWSC's failure to timely supplement could simply be the result of negligence, as opposed to an intent to avoid its discovery obligations. Further, additional discovery can ameliorate any unfair prejudice to CEWR.

## **2. Amendments to Application**

### **a. CLWSC's Motion to Amend**

CLWSC's argues that it has a right to amend its application, similar to the right to amend a petition found the Texas Rules of Civil Procedure, and points out that an applicant may amend an application if there is good cause.<sup>4</sup> CLWSC submits that the correction of an incomplete or incorrect application meets the requirement of good cause. Also, CLWSC's experts maintain that the amendments are not material and do not change the rates it requested in its application.

CLWSC further alleges that its revisions to its application are not discretionary changes. According to CLWSC, CEWR claimed during the June 8, 2011 prehearing conference that CLWSC's changes to the application were merely discretionary, or that CLWSC chose to use one methodology in preparing the original application but now chooses to use another. CLWSC argues that its experts' affidavits attached to its motion show that those allegations are not true.

Additionally, CLWSC contends that its prefiled testimony is analogous to an expert witness' report. According to CLWSC, the courts have determined that an expert may refine calculations or perfect a report through the time of trial or expand on an already disclosed subject.

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<sup>4</sup> 30 TAC § 291.25(g).

The primary amendments to CLWSC's application are an index update and changes to the depreciation lives of CLWSC's assets. Regarding the update to the Handy-Whitman index, CLWSC's experts stated that "[w]hile the change in Handy-Whitman data affects the computations of a large number of items; the fiscal impact is relatively minimal. . . . The magnitude of the change is less than 1% in the net book value of trended assets at the end of the test year."<sup>5</sup> Regarding the depreciation issue, the expert stated that when preparing the initial application, "we were unaware that the TCEQ offers two different sets of approved depreciation lives." CLWSC only discovered that it had used two different sets of depreciation service lives when it was brought to its attention by the ED during discovery. CLWSC's expert asserts that "only [11] depreciation service lives were revised, not hundreds."<sup>6</sup>

**b. CEWR's Response**

CEWR's first argument is that CLWSC misconstrues its right to amend an application and argues that a detailed application to change water rates bears no resemblance to a petition in a civil case, which only "consist[s] of a statement in plain and concise language of the plaintiff's cause of action." On the other hand, a utility's rates can change pursuant to its application before any preliminary or evidentiary hearing has been held, while in civil cases, relief requested in the petition can only occur after a trial and entry of a judgment.

CEWR then argues that the changes are material and are tantamount to the filing of a new application. CEWR asserts that although the net is not a large number, the revisions are material because of the amount of data that has been modified and the wide swings in the variation of those data points. Asset data is important in this case because CLWSC has never set its rate base, and because every item in its asset list must be reviewed for original cost and depreciation cost. It is CEWR's opinion that a sophisticated utility like CLWSC should have known the value of its assets before it filed its rate application.

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<sup>5</sup> Gebhard affd, pg. 2.

<sup>6</sup> Loy affd, pg. 23.

According to CEWR, an application is more than just a revenue requirement and a set of rates as two applications which result in the same rates could have widely varying expenses. Therefore, CEWR posits that CLWSC's amended application should be considered a new application because the supporting data has changed. CEWR argues that in the *Waterco* case, the TCEQ rejected new data presented at hearing because it amounted to the submission of a completely new application after discovery had ended.<sup>7</sup>

CEWR argues that the changes to the application are discretionary and unnecessary, thereby negating good cause. Regarding the trending study, CEWR claims that CLWSC's expert has changed his story. In the prefiled testimony, Dr. Gebhard stated that the Handy-Whitman trending indices had not been updated correctly. Now, CEWR states that Dr. Gebhard's position is that the files containing the indices had been corrupted. CEWR asserts that these two stories cannot be reconciled. Regardless of which version of Dr. Gebhard's story is believed, neither constitutes good cause for amendment of the application.

CEWR further asserts that CLWSC's negligence in preparing the application does not constitute good cause for amending it. If the consultants made mistakes in preparing the application, CEWR maintains that the utility's customers should not bear the costs of the consultant's negligence.

**c. The ED's Response**

The ED states that there is no reason to look to analogies in the Texas Rules of Civil Procedure regarding expert reports or amendments to pleadings as CLWSC suggests. According to the ED, the law regarding the requirements for water rate applications is clear and the factors to be considered in applying that law are well-established in 30 TAC §§ 291.25(b) and 291.25(g). Section 291.25(b) provides that "[a] utility filing for a change in rates . . . shall be prepared to go forward at a hearing on the data which has been submitted under subsection (a)

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<sup>7</sup> *Application of Waterco, Inc. to Change Water Rates in Trinity and Walker Counties*, SOAH Docket No. 582-04-6463, TCEQ Docket No. 2004-0630-UCR.

of this section and sustain the burden of proof of establishing that its proposed changes are just and reasonable.” Section 291.25(g) states that “[t]he items in a rate change application may be modified on a showing of good cause.”

Regarding what constitutes good cause, the ED looks to guidance from the Commission and balances two interests: (1) whether data submitted is accurate; and (2) whether the applicant is presenting a “moving target” by providing new information late in the game which prevents the other parties from fully scrutinizing and verifying the cost information. The ED states that it would frustrate the parties’ attempts to scrutinize costs if they were to change significantly during the pendency of a case and after the parties relied on the previous representations. Also, an unreasonable delay in correcting erroneous data could drain the resources of ratepayers thereby limiting their ability to fully review the application.

The ED summarizes the two major changes to the application found in the prefiled testimony: (1) changing the indices used in trending; and (2) changing the service lives of the depreciable assets.<sup>8</sup> It is the ED’s position that none of the changes are sufficient to warrant striking the amendments. He argues the recovery of rate case expense awarded at the conclusion of the case may provide the proper analysis to protect the ratepayers. If necessary and reasonable to do so, this expense could be adjusted to ameliorate any harm done to the ratepayers if CLWSC failed to use reasonable care in preparing the application and in timely apprising the parties of the changes in its cost data.

Regarding the trending indices, the ED states that the corrections were necessary and would have recommended the same changes in his prefiled testimony. Therefore, according to the ED, the amendments should not be stricken on that basis.

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<sup>8</sup> In the ED’s opinion, the other changes are not central to the application and do not cause him the same degree of concern as the changes to the indices and service lives.

However, the changes made to the service lives create more concern for the ED because service lives must remain consistent once they are used to determine a rate. The ED maintains that all suggested service lives are only estimates and they are not going to be absolutely accurate. When a sophisticated utility like CLWSC makes changes in service lives, the ED looks more closely at the changes. According to the ED, once an asset has already been assigned an estimated service life, that asset should not be given a new service life in a subsequent application because changes in estimates can be manipulated.

The ED stated that he had “analyzed the service lives in CLWSC’s previous rate case, the original filings in this rate case, and found that the proposed application amendment is not consistent with [TCEQ’s guidance document] RG 354 or with the application-recommended services lives.”<sup>9</sup> However, the ED points out a change in an estimate should be based on documented evidence that the service lives for such assets are physically different than what was previously reported. The ED is concerned with CLWSC’s change in the service lives of its assets, although the ED contends that the change provided more consistency with the previous rate case than the originally filed application in this case. Because CLWSC did not submit a study recommending a change in service lives, it is the ED’s position that the amended application makes it more consistent with estimates used in the previous application.

### **3. The ALJ’s Analysis**

The ALJ finds that there is good cause for CLWSC to amend its application. As stated by CLWSC’s experts, they discovered errors in the original application through the discovery process and while they were preparing their prefiled exhibits. These errors must be remedied so that a well-reasoned decision can be made on CLWSC’s application. Therefore, the ALJ sees no merit in striking the amendments and proceeding to hearing on a flawed application.

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<sup>9</sup> ED’s Resp., pg. 5.

Furthermore, the cause of the errors can be addressed if CLWSC requests its rate case expenses. In responding to such a request, the ALJ will consider whether CLWSC's expenses are reasonable, necessary, and in the public interest.<sup>10</sup> If CLWSC's errors were the result of negligence or the failure to exercise due care in completing the application, then it may not be appropriate for CLWSC to recover expenses incurred to amend its application or to supplement its initial discovery responses.

The issue of whether CLWSC has made its application a moving target through its amendments can be addressed through the use of additional discovery and time for the preparation of CEWR's and the ED's prefiled testimony. To address CLWSC's failure to timely supplement its discovery responses, CLWSC must identify the changes between its prior application and its revised application, to the extent it has not already done so, in its motion to amend and attached affidavits. This includes specifying the changes caused by the updates to the Handy-Whitman data and the changes to the service lives of each asset.

In addition, the parties must submit a revised procedural schedule that allows sufficient time for CLWSC to identify and document the changes, and for CEWR and the ED to conduct additional discovery, if necessary, and to prepare prefiled testimony. The parties should suggest at least three alternative dates for the evidentiary hearing. The parties must submit this agreed schedule by **August 15, 2011**.

**THEREFORE, it is ORDERED:**

1. CLWSC shall clearly identify in writing all changes to its application, to the extent it has not done so in its prefiled testimony. The documents CLWSC prepares pursuant to this Order must enable CEWR to easily identify the changes to the application, including any changes to spreadsheets, native files, or other documents submitted in response to a CEWR discovery request.

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<sup>10</sup> 30 TAC § 291.28(7).

2. The parties must submit a revised procedural schedule by August 15, 2011.

**SIGNED August 2, 2011.**

A handwritten signature in black ink, appearing to read "Kerrie Jo Qualtrough", written over a horizontal line.

**KERRIE JO QUALTROUGH  
ADMINISTRATIVE LAW JUDGE  
STATE OFFICE OF ADMINISTRATIVE HEARINGS**

TEXAS COMMISSION ON ENVIRONMENTAL QUALITY



**AN ORDER Approving the Application Of  
SJWTX, Inc. d/b/a Canyon Lake Water Service Company to Change Water Rates;  
in Comal and Blanco Counties; CCN No. 10692  
TCEQ Docket No. 2010-1841 UCR;  
SOAH Docket No. 582-11-1468**

On \_\_\_\_\_, the Texas Commission on Environmental Quality (TCEQ or Commission) considered the application of SJWTX d/b/a Canyon Lake Water Service Company for water rate/tariff change and for recovery of rate case expenses through imposition of a surcharge on water customers. Administrative Law Judges (ALJs) Kerrie Jo Qualtrough and Penny A. Wilkov of the State Office of Administrative Hearings (SOAH) presented a Proposal for Decision (PFD) recommending that the Commission approve the requested rate change, with modifications. After considering the PFD, the Commission adopts the following Findings of Fact and Conclusions of Law.

**FINDINGS OF FACT**

**General and Procedural Findings**

1. SJWTX, Inc. d/b/a CLWSC (CLWSC) holds Water Certificate of Convenience and Necessity (CCN) No. 10692.
2. On August 27, 2010, CLWSC submitted to the Commission an application for water rate/tariff changes (Application) in Comal County and southern Blanco County, Texas. The application used a test year of March 31, 2009, through March 31, 2010. The Application was declared administratively complete on October 6, 2010.
3. CLWSC timely and properly provided notice of the proposed rate changes to its ratepayers and affected persons.
4. In the Application, CLWSC sought to raise its rates in two phases. The first phase (Phase 1) became effective for the Canyon Lake Shores, North Point, Rust Ranch, Stallion Springs, Summit North and Triple Peak customers on October 27, 2010, and

effective for the Glenwood customers on November 27, 2010. The second phase (Phase 2) sought to increase the rates beginning March 15, 2011.

5. Within sixty days of the effective date of the proposed rate changes at least ten percent of CLWSC's customers filed protests to the rate changes.
6. On November 16, 2010, the Application was referred to SOAH for a contested case hearing.
7. On January 6, 2011, ALJ Kerrie Jo Qualtrough convened a preliminary hearing in this matter in Austin, Texas. The following appeared and were admitted as the parties in this case: CLWSC; Coalition for Equitable Water Rates (CEWR); Thomas C. Stuebben; Thomas F. Acker; Lawrence J. Hanson; TCEQ's Executive Director (ED); and TCEQ's Office of Public Interest Counsel (OPIC).
8. Prior to issuance of Order No. 1, Mr. Stuebben, Mr. Acker, and Mr. Hanson withdrew as parties and agreed to be represented by CEWR.
9. On February 25, 2011, CEWR and CLWSC submitted a joint motion to adopt interim rates, proposing that the Phase 1 rates remain in effect during the pendency of this proceeding. On March 1, 2011, the ALJ issued Order No. 2 granting the joint motion.
10. Interim rates were set at the Phase 1 levels, and CLWSC has charged those Phase 1 rates throughout this case.
11. On May 20, 2011, CLWSC filed its prefiled testimony. Included with CLWSC's prefiled testimony were amendments to CLWSC's Application.
12. On May 31, 2011, CEWR filed a Motion to Strike CLWSC's prefiled testimony and to abate the proceeding based on CLWSC's failure to timely supplement its discovery responses. CLWSC filed a response to CEWR's Motion on June 7, 2011. A prehearing conference on CEWR's motion to strike was held on June 8, 2011.
13. On June 24, 2011, CLWSC filed a Motion to Amend Rate Change Application. On July 14, 2011, the ED and CEWR filed Responses to CLWSC's Motion to Amend its Application.
14. On August 2, 2011, the ALJ issued Order No. 8 ruling on the Motion to Strike and the Motion to Amend Rate Change Application. Order No. 8 found that CLWSC had failed to meet its obligation to timely supplement its discovery responses as required by the Texas Rules of Civil Procedure. To address this failure, Order No. 8 required CLWSC to identify the changes in the prior application and the revised application.
15. CEWR filed its prefiled testimony on October 31, 2011, and the ED filed his prefiled testimony on January 17, 2012.

16. At the parties' request, ALJs Qualtrough and Wilkov bifurcated the evidentiary hearing in this proceeding. The ALJs convened the first evidentiary hearing on March 26 through March 30, 2012. An additional day of hearing was held on April 19, 2012. The first evidentiary hearing concerned only the merits of the Application and CLWSC's rate request. The parties then filed closing arguments on June 21, 2012, and responses on August 6, 2012.
17. As proposed by the parties, the ALJs convened a second evidentiary hearing on August 22 and 23, 2012, on the issue of CLWSC's rate case expenses. On September 24, 2012, the parties submitted closing arguments regarding expenses. With the filing of responses on October 8, 2012, the evidentiary record closed.

### **Background**

18. CLWSC is a privately owned, retail public utility in the business of providing water service to a population of approximately 36,000 people through 9,200 service connections in a service area comprising about 237 square miles around Canyon Lake in western Comal County and southern Blanco County.
19. CLWSC is wholly owned by SJW Corporation (SJW Corp.), which is operated as a holding company with four subsidiaries: San Jose Water Company (SJWC); SJW Land Company; CLWSC; and the Texas Water Alliance Limited.
20. CLWSC, SJW Corp., SJWC, SJW Land Company, and Texas Water Alliance are affiliates.
21. SJWC has employees who perform certain services for the benefit of CLWSC.
22. SJWC is a California investor-owned utility which serves approximately 225,000 service connections in the San Jose, California area.
23. On May 31, 2006, CLWSC purchased the assets of the Canyon Lake Water Supply Corporation (WSC). The WSC began operations in 1994 through the consolidation of forty-six water systems.
24. In 2006, western Comal County was experiencing high population growth. The WSC experienced difficulty financing additional construction for water utility facilities needed to meet growing demand for water service.
25. The WSC's membership approved the asset acquisition agreement with CLWSC, with 76.3% voting to sell the WSC's assets to CLWSC. On May 31, 2006, the WSC assets were purchased by CLWSC.
26. The material terms of the asset purchase agreement were that CLWSC would: (1) acquire all system assets, (2) assume or discharge assumed liabilities that, as defined, including approximately \$19 million in WSC debt and other liabilities, (3) pay the WSC

\$3.2 million in cash for the WSC's assets, (4) pay certain transaction costs and reimbursable seller income tax, as defined, and (5) agree to a rate moratorium on increases through October 4, 2007.

27. On December 22, 2005, CLWSC filed a sale, transfer, or merger application (STM) with TCEQ. The ED reviewed the STM application, and the final order on the STM was issued on June 30, 2006.
28. After CLWSC acquired the WSC water system assets, the following water systems were purchased: two public water systems (PWSs) from the Emerald Valley Independent Aquatic Network, Ltd.; four PWSs from Rancho Del Lago, Inc., all assets of the North Point Homeowners WSC; Comal County assets of the Bexar Metropolitan Water District; and the assets of the City of Bulverde.
29. CLWSC currently has seven PWSs: Canyon Lake Shores; Triple Peak; Glenwood; Northpoint; North Summit; Stallion Springs; and Rust Ranch.
30. At the end of the test year, CLWSC had a total of approximately 9,068 active connections.
31. CLWSC's proposed Phase 2 rates, as compared with its previous rates, are as follows:

**Monthly Minimum Charge by Meter Size**

Previous Rates		Proposed Phase 2 Rates	
Size in inches	Charge	Size in inches	Charge
5/8 x 3/4	\$30.20	5/8	\$51.60
3/4	\$45.29	3/4	\$77.38
1	\$75.48	1	\$128.96
1 1/2	\$150.95	1 1/2	\$257.90
2	\$241.52	2	\$412.65
3	\$452.85	3	\$773.71
4	\$905.69	4	\$1,547.40
6	\$1,509.48	6	\$2,579.00
Bulk	\$241.52	Bulk	\$412.65

**Charges Per 1000 Gallons (G)**

<b>Previous Rates</b>		<b>Proposed Phase 2 Rates</b>	
<b>Size in inches</b>	<b>Charge</b>	<b>Size in inches</b>	<b>Charge</b>
5/8 x 3/4	\$3.30 first 2,000G \$3.60 next 8,000G \$4.10 next 15,000G \$5.20 over 25,000G	5/8 x 3/4	\$5.64 first 2,000G \$6.15 next 8,000G \$7.01 next 15,000G \$8.88 over 25,000G
3/4	\$3.30 first 4,000G \$3.60 next 16,000G \$4.10 next 30,000G \$5.20 over 50,000G	3/4	\$5.64 first 4,000G \$6.15 next 16,000G \$7.01 next 30,000G \$8.88 over 50,000G
1	\$3.30 first 6,000G \$3.60 next 24,000G \$4.10 next 45,000G \$5.20 over 75,000G	1	\$5.64 first 6,000G \$6.15 next 24,000G \$7.01 next 45,000G \$8.88 over 75,000G
Meter size greater than 1	\$4.25 all gallons	Meter size greater than 1	\$7.26 all gallons

**Rate Base**

32. CLWSC has three classes of assets: (1) assets acquired from the WSC for which there is insufficient supporting documentation of original costs (pre-acquisition assets); (2) assets acquired from the WSC that were financed through the Texas Water Development Board (TWDB); and (3) assets acquired or installed by CLWSC after it acquired the WSC's assets (post-acquisition assets).
33. There is sufficient documentation to support CLWSC's original cost of the pre-acquisition assets financed through the TWDB and the post-acquisition assets.
34. Since acquiring the WSC, CLWSC has filed three rate applications. In the first two applications filed in 2007 and 2008, CLWSC's used the booked costs as its original cost estimates. In the 2008 application, CLWSC requested that the TCEQ make a rate base determination, and CLWSC relied on its booked values to establish original cost.
35. Two trending studies should have similar original costs for similar assets installed in the same year.
36. In 2007, CLWSC conducted a trending study for the Rancho del Lago (RDL) water system. This trending study was performed before CLWSC acquired the developer-owned RDL system.
37. In 2010, CLWSC conducted a trending study, and CLWSC relies on this 2010 trending study to estimate the original cost of its pre-acquisition assets that do not have sufficient documentation of original cost.

38. For PVC pipe installed in 1984, the values found in the 2010 trending study exceed the values found by the 2007 trending study by as much as 47% for all pipe other than two-inch diameter PVC pipe.
39. The 2007 trending study and the 2010 trending study do not have similar original costs for PVC pipe installed in the same year.
40. The 2010 trending study failed to recognize the WSC's capitalization policy that treated all items under \$2,500 as expenses.
41. The 2010 trending study did not account for the different capitalization policies of the WSC and CLWSC.
42. If the WSC had expensed an asset and it was paid by the WSC members, the members would pay for that same asset again if CLWSC included it within its rate base.
43. Approximately 174 assets listed in the trending study have a trended original cost of less than \$2,500.
44. The trending study in this case is not a reliable estimate of original cost when compared to other methods.
45. CLWSC's use of booked values in its 2007 and 2008 rate cases to estimate original cost indicates that the booked values are reliable.
46. The 2010 trending study provided support for the booked values of the pre-acquisition assets and provided a complete list of those assets.
47. To allow a utility to earn a return on contributions in aid of construction (CIAC) would be unjust since customers would be paying twice for the same property. Customer- and developer- CIAC is excluded from the rate base because the utility has not made an investment upon which it should earn a return.
48. CLWSC properly excluded CIAC from its rate base for its post-acquisition assets.
49. The Asset Purchase Agreement between CLWSC and the WSC is silent on the issue of CIAC, and is no indication of the parties' intent on whether the WSC's members were to be compensated for their CIAC through CLWSC's acquisition of the WSC's assets.
50. Through the WSC dissolution process, the WSC members received money based on their two-year water usage, not on the amount of the members' contributions.
51. There is no correlation between the members' contributions to the WSC and the money they received through the dissolution process.

52. From 1994 to 2005, the WSC received \$10,978,042 in donated equipment and systems; \$723,592 in tap fees; \$672,327 in equity buy-in fees; \$229,205 in capital recovery fees; \$219,470 in member fees; \$629,142 in CIAC; and \$327,464 in line extensions. These payments are CIAC.
53. Dr. Thomas G. Gebhard, in a letter to the WSC's board of directors in 2005 estimated that the WSC had received \$11,097,000 in CIAC from its members and developers.
54. CLWSC's proposed rate base valuation contains CIAC. CLWSC did not exclude CIAC from its rate base for those pre-acquisition assets for which there is insufficient documentation of original cost.
55. In acquiring the assets of the WSC, CLWSC agreed not to raise rates for two years (two-year stay-out provision) and assumed the obligation to bring the WSC up to standards at an unknown cost.
56. The value of the two-year stay-out provision and the assumption of an open-ended obligation to improve the water system is unquantifiable.
57. Cost-free capital occurs when a utility does not use its own funds to obtain plant assets.
58. The total purchase price CLWSC paid for the WSC's assets was \$26,497,000, the total original cost of the WSC's assets was \$37,177,760, with an accumulated depreciation of \$5,956,303, the net book value of the assets was \$31,221,457, and the original cost of the WSC's assets and construction in progress only was \$26,158,736.
59. The difference between the STM's net book value of \$31,221,457 and the STM's purchase price of \$26,497,000 indicates that there is cost-free capital in CLWSC's rate base.
60. CLWSC proposed rate base valuation contains cost-free capital. CLWSC did not exclude cost-free capital from its rate base for those pre-acquisition assets for which there is insufficient documentation of original cost.
61. The WSC used an accounting system that differs from CLWSC's accounting system. The WSC did not track CIAC in the same manner as CLWSC tracks CIAC. The CIAC received by the WSC cannot be tracked to specific assets. There are no records available to reliably remove individual, contributed assets from CLWSC's rate base.
62. CLWSC proposed to include \$4,900 in prepayments in its rate base.
63. Accumulated Deferred Federal Incomes Taxes (ADFIT) is a source of cost-free capital.
64. CLWSC's rate base should be reduced to exclude \$268,037 in ADFIT.

- 65. CLWSC’s original cost estimate should be reduced by \$46,535 because the existence of certain assets was not verified by inspection. Therefore, those assets were not used and useful to CLWSC in providing service.
- 66. Intangible costs for consulting work, system acquisition costs, and “50 years planning” are non-recurring costs that should be amortized. These costs are not depreciable. These costs in the amount of \$237,219 should be removed from CLWSC’s rate base.
- 67. The \$150,000 cost of the trending study is non-recurring and should be amortized.
- 68. CLWSC’s rate base is:

Item	Amount
Original Cost	\$64,206,901
Accumulated Depreciation	<11,248,826>
<b>Net Book Value</b>	<b>\$52,958,075</b>
Working Cash Allowance	625,726
Materials and Supplies	361,235
Prepayments	4,900
ADFIT	<268,037>
Developer CIAC	<14,812,965>
Advances	<772,550>
<b>Total Rate Base (Total Invested Capital)</b>	<b>\$38,096,384</b>

**Salaries and Wages - Corporate Allocations**

- 69. Administrative and general expenses were transferred monthly from SJWC to CLWSC for overhead expenses.
- 70. There were three categories of expenses and three ways to calculate the annualized expense allocations:
  - (a) salaries and associated labor costs and travel and entertainment expenses were allocated using a one-month-per-year representative time study;
  - (b) property-related expenses for the corporate headquarters in San Jose, California, were allocated based on a square footage of the office; and
  - (c) corporate and accounting services were allocated by proportion of revenue among each of the affiliates.
- 71. Corporate costs for executive salaries and travel and entertainment for those employees who recorded time spent on CLWSC operations are reasonable and necessary, but all bonuses and stock options should be disallowed.

72. Apportioning salary-related and travel and entertainment expenses based on connections, rather than on a time study, ensures that costs to each affiliate are calculable relative to all affiliates and that the prices charged are no higher than those costs charged to other affiliates by the supplying affiliate.
73. A reasonable and necessary allocable expense to CLWSC for general salaries is \$139,789.55 and \$5,118 for travel and entertainment expenses.
74. The property costs for maintenance and upkeep of the SJWC headquarters are not allocable to CLWSC because CLWSC's proposed allocation does not comport with statutory criteria and the expenses are not relatable to utility services provided to CLWSC ratepayers, and thus, \$27,918 should be disallowed.
75. Some costs of corporate and accounting services are reasonable and necessary, and should be allocated to CLWSC, but the costs of publicly trading stock should be disallowed.
76. A reasonable and necessary allocable expense for corporate and accounting services is \$27,808.
77. The method of using the revenue of two affiliates in proportion to expenses to allocate corporate and accounting services is a reasonable method to apportion corporate expenses and ensures that costs to each affiliate are calculable relative to all affiliates and that the prices charged are no higher than those costs charged to other affiliates by the supplying affiliate.

### **Other Expenses**

78. CLWSC has included the following expenses for the thirty-five local employees of CLWSC: dental insurance for employees; medical insurance for employees and dependents; contributions to a Health Saving Account (HSA), and a free base meter fee.
79. The \$63,750 HSA expense and the \$17,626 free base water fee expense are not reasonable and necessary and should be disallowed, while the medical and dental expenses are reasonable and necessary.
80. Providing health and dental for employees and dependents presents sufficient incentive to attract and retain employees.
81. There is no basis to provide additional incentives above what is typically provided to employees, or what a utility of its size would be expected to provide in Texas, including an HSA or free base water fee.
82. The adjustment to bad debt/uncollectible accounts of \$47,736 beyond the test year amount of \$69,003 due to anticipated bad debt collection rates is speculative and not

reasonable and necessary. The test year amount of \$69,003 is the correct amount that should be included in allowable expenses.

- 83. Fees in the amount of \$53,205 paid to the CLWSC board of directors are not reasonable and necessary because the services are not customary and the fees are duplicative and related to shareholder business only.
- 84. Rate case expenses of \$57,250 were included in operations and maintenance expenses but should be removed.

**Normalization**

- 85. The volumetric consumption data gathered from averaging two years to arrive at a normalized water usage is insufficient to adjust actual expenses based on a known and measureable change from the historical test year expenses.
- 86. The reasonable and necessary purchased water expense, unadjusted for normalization, is \$1,141,619.
- 87. The reasonable and necessary chemical and treatment expense, unadjusted for normalization, is \$91,100.
- 88. The reasonable and necessary utilities expense, unadjusted for normalization, is \$459,763.
- 89. The reasonable and necessary office expense, including bad debt expense, unadjusted for normalization, is \$332,128.
- 90. The following expenses are reasonable and necessary to provide service to the ratepayers:

Category	Amount
Salaries	\$1,084,930.55
Contract Services	289,988
Purchased Water	1,141,619
Chemicals and Treatment	91,100
Utilities	459,763
Repairs and Maintenance	996,704
Office Expense	332,128
Accounting and Legal	84,359
Insurance	311,422
Miscellaneous	213,798
<b>Total</b>	<b>\$5,005,811.55</b>

### **Depreciation Expense**

91. CLWSC's reasonable and necessary annual depreciation expense totals \$1,897,872.

### **Taxes Other than Federal Income Taxes**

92. CLWSC's reasonable and necessary annual property and other non-income taxes total \$142,179.

### **Federal Income Taxes**

93. CLWSC's reasonable and necessary annual federal income taxes total \$\_\_\_\_\_.

### **Other Revenues**

94. CLWSC's annual other revenues total \$284,037.

### **Rate of Return**

95. CLWSC's Application listed only two debts: a Series A note in the amount of \$15,000,000 at 6.27% interest and a Bexar Metropolitan Water District (BMET) loan, related to a utility purchase, in the amount of \$971,401 at 6.50% interest.
96. An intercompany loan from SJW Corp. in the amount of \$11,250,000 at 2.25% interest was not included in CLWSC's cost of debt.
97. During the test year, the intercompany loan increased from \$9,850,000 with a monthly interest accrual of \$18,334.38, to \$11,250,000 with a monthly interest accrual of \$21,796.88. During the same time period, there were five payments recorded, totaling \$1.3 million.
98. The intercompany loan has been on the books from May 1, 2007, until December 31, 2010, with the balance increasing from \$1 million to \$11,210,000 and the interest incrementally increasing in relation to the balance.
99. CLWSC listed the debt on its statements of cash flow as "borrowing from a line of credit," and listed it in a column marked as "financing activities."
100. The loan was listed on the SJW Corp. financial statements and SJW Corp. was entitled to repayment.

101. CLWSC's cost of debt calculation should have included the actual debt of \$11,250,000 at 2.25% interest.
102. CLWSC has a capital structure of 29.64% equity and 70.36% long-term debt.
103. The return on equity should be calculated using the return on equity worksheet (worksheet), rather than by applying a market-based risk analysis.
104. Applying the factors on the worksheet, including the Baa public utility bond average of 6.63%, a 10.88% rate of return on equity is reasonable, including upward adjustments to reflect unstable populations, aging facilities, good management, conservation efforts, and high quality of service.
105. With the intercompany loan factored into CLWSC's cost of debt, and after applying the worksheet factors to the return on equity, a fair rate of return for CLWSC to receive on its water-service rate base is 6.46%.

#### **Acquisition Adjustments**

106. CLWSC's audited books include acquisition adjustment amounts, both positive and negative, that result in a net acquisition adjustment amount of approximately \$4 million.
107. CLWSC's proposal to maintain its acquisition adjustment amounts on its books, amortize the amounts over time, and omit those amounts from ratemaking calculations in this docket is reasonable.
108. These findings of fact do not affect the treatment of CLWSC's acquisition adjustment amounts for ratemaking purposes in a future rate case if CLWSC proposes to include those amounts in future ratemaking calculations.
109. These findings of fact do not dictate whether CLWSC's acquisition adjustment amounts will be approved in future rate cases.

#### **Plant Held for Future Use**

110. CLWSC's audited books include approximately \$3.2 million in costs that represent an amount paid to the Bexar Metropolitan Water District to acquire a large CCN service area.
111. CLWSC's proposal to maintain this amount in its Plant Held for Future Use (PHFU) account, amortize the amount over time, and omit the amount from ratemaking calculations in this docket is reasonable.

112. These findings of fact do not affect the treatment of CLWSC's PHFU amount for ratemaking purposes in a future rate case if CLWSC proposes to include that amount in future ratemaking calculations.
113. These findings of fact do not dictate whether CLWSC's PHFU will be approved in future rate cases.

**Rate Collection and True-Up**

114. On August 27, 2010, CLWSC mailed a Notice of Proposed Rate Change to its customers. The notice stated that the Phase 2 rates would go into effect on March 15, 2011.
115. The true-up in this proceeding relates back to the noticed effective date of March 15, 2011.

**Rate Design**

116. The rate structure incorporates the ED's recommended allocations.
117. The following rate structure will recover CLWSC's revenue requirement.

**Monthly Minimum Charge by Meter Size**

Size in inches	Charge
5/8	
3/4	
1	
1 1/2	
2	
3	
4	
6	
Bulk	

**Charges Per 1,000 Gallons (G)**

Size in inches	Charge
5/8 x 3/4	
3/4	
1	
Meter size greater than 1	

**Rate Case Expenses**

118. CLWSC incurred rate case expenses in the amount of \$971,758.39 through August 23, 2012, as follows:

<b>Firm</b>	<b>Amount</b>
GDS Associates, Inc.	\$481,766.49
ValueScope, Inc.	55,213.75
The Terrill Firm, P.C.	361,344.74
Law Offices of Mark H. Zeppa	69,053.21
Expenses	4,380.17
<b>Total</b>	<b>\$971,758.39</b>

119. Rate case expenses in this case were not a normal, recurring expense of CLWSC's operations.
120. Evidence admitted during the August 2012 hearing on CLWSC's rate case expenses shows that CLWSC knew that it was producing inaccurate or soon-to-be-outdated discovery responses to CEWR in April 2011.
121. CLWSC incurred \$70,867.03 in rate case expenses in responding to Order No. 8. The ALJ issued Order No. 8 to remedy CLWSC's failure to meet its discovery obligations. The rate case expenses CLWSC incurred in responding to Order No. 8 were unreasonable and unnecessary. CLWSC's rate case expenses should be reduced by \$70,867.03.
122. CLWSC's rate case expenses should be reduced by \$16,354.69 in unreasonable and unnecessary legal expenses for preparing closing arguments and responses.
123. CLWSC's rate case expenses should be reduced by \$9,067.50 in unreasonable and unnecessary consultant expenses for preparing closing arguments and responses.
124. CLWSC's rate case expenses should be reduced by \$45,213.75 for the work attributable to Gregory E. Scheig. CLWSC did not provide sufficient detail to determine whether Mr. Scheig's expenses are reasonable, necessary, and in the public interest. Mr. Scheig's testimony is not credible because he could not recall some of the details of the work he performed and he testified erroneously regarding his review of the opposing parties' prefiled testimony.
125. The estimated rate case expenses of \$16,375 for CLWSC to participate in the August 22 and 23, 2012, evidentiary hearing are reasonable and necessary.
126. The estimated rate case expenses of \$22,500 for CLWSC to respond to the PFD and attending agenda are reasonable and necessary.

127. CLWSC's rate case expenses are reduced by \$595 for Mary Elena Eick's travel because CLWSC did not show that this expense was reasonable, necessary, and in the public interest. There is no indication that Ms. Eick performed work for CLWSC during the same month CLWSC incurred this \$595 travel expense.
128. CLWSC's rate case expenses should be reduced by \$8 for Thomas A. Hodge's parking on March 22, 2011 because he was a witness at the Natural Resources Committee and testified against HB 206. This expense is not reasonable or necessary.
129. CLWSC's rate case expenses are reduced by \$270 that was incorrectly billed to the CLWSC account by GDS Associates, Inc.
130. CLWSC had \$856,742.42 in rate case expenses that are reasonable and necessary.
131. CLWSC previous rates generated \$6,917,243 in annual revenue.
132. CLWSC's proposed rates would have generated \$11,568,442 in annual revenue.
133. CLWSC's proposed rates would have increased its annual revenue by \$4,651,199.
134. CLWSC's just and reasonable rates as determined by the Commission after this contested case hearing will generate \_\_\_\_\_ in annual revenue.
135. CLWSC's just and reasonable rates as determined by the Commission after this contested case hearing will increase its annual revenue by \_\_\_\_\_.
136. \_\_\_\_\_ is \_\_\_\_\_% of \$4,651,199.
137. CLWSC's new rates generate revenue that is \_\_\_\_\_ 51% of the increase in revenue that would have been generated by CLWSC's proposed rate.
138. On July 21, 2011, CEWR sent a settlement offer to CLWSC. CEWR offered to settle this proceeding if, *inter alia*, CLWSC agreed to a 20% increase in its revenue requirement and a net book value that resulted in invested capital of \$25.6 million.
139. CEWR's settlement offer would have generated \$8,300,692 in total annual revenue.
140. CLWSC's revenue requirement as determined in this contested case hearing will generate revenue \_\_\_\_\_ \$8,300,692.
141. If the 51% Rule and the Settlement Rule are met, it is reasonable and appropriate for CLWSC to recover its reasonable and necessary rate case expenses as a surcharge of \_\_\_\_\_ per connection per month.
142. If the 51% Rule and the Settlement Rule are met, CLWSC should be ordered to cease billing the surcharge at the earliest of the following dates: the billing cycle in which the

full amount has been billed to the customers, or the billing cycle in which the full amount has been collected.

143. If the 51% Rule and the Settlement Rule are met, CLWSC should be ordered to file a report every six months to the Utilities Financial Review Section of the TCEQ including the total amount of surcharge billed, the total amount of surcharge collected, and any related bad debt write offs. This report should continue until billing ceases, with the final report reconciling to the amount of the rate case expenses allowed in this case.

### CONCLUSIONS OF LAW

1. CLWSC is a retail public utility as defined in Tex. Water Code § 13.002(19).
2. CLWSC is a “utility” as defined by Tex. Water Code § 13.002(23).
3. CLWSC bears the burden of proof that its proposed rates are just and reasonable. Tex. Water Code § 13.184(c).
4. Because CLWSC’s Application only seeks to increase rates in areas outside of the boundaries of a municipality, the Commission has exclusive, original jurisdiction to consider an application for a rate increase filed by a water and sewer utility. Tex. Water Code § 13.042(e).
5. All required notices of the Application and the contested case hearing were given as required by law. Tex. Water Code § 13.187; Tex. Gov’t Code §§ 2001.051 & 2001.052.
6. The ALJs conducted a contested case hearing and proposed a decision on the application under the authority of chapter 2003 of the Texas Government Code and chapter 13 of the Texas Water Code.
7. Payment to affiliated interests for costs of any services, or any property, right or thing, or for interest expense may not be allowed either as capital cost or as expense except to the extent that the regulatory authority finds that payment to be reasonable and necessary. A finding of reasonableness and necessity must include specific statements setting forth the cost to the affiliate of each item or class of items in question and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations. Tex. Water Code § 13.185(e)
8. Based on the findings of fact and conclusions of law, the revenue requirement, after being adjusted for the modifications required by this Order, is based on CLWSC’s reasonable and necessary operating expenses.
9. The Commission in setting the rates for water service, must fix a utility’s overall revenues at a level that will permit the utility a reasonable opportunity to earn a

reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses and preserve the financial integrity of the utility. Tex. Water Code § 13.183.

10. The cost of capital is the composite of the cost of the various classes of capital used by the utility: (1) debt capital is the actual cost of debt; and (2) equity capital is based upon a fair return on its value. 30 Tex. Admin. Code § 291.31.
11. The Commission must also consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management. Tex. Water Code § 13.184.
12. Based on the findings of fact and conclusions of law, a rate of return of 6.46% will permit CLWSC a reasonable opportunity to earn a reasonable return on its invested capital.
13. Based on the findings of fact and conclusions of law, CLWSC's revenue requirement as determined in the Order is reasonable and necessary and sufficient to permit CLWSC a reasonable opportunity to earn a reasonable return over and above its reasonable and necessary operating expenses and preserve CLWSC's financial integrity.
14. CLWSC cost of service is comprised of two components: allowable expenses and return on invested capital. 30 Tex. Admin. Code § 291.31(a). The term "invested capital" is also referred to as the "rate base."
15. To determine CLWSC's rate base, the original cost of the assets must be calculated. 30 Tex. Admin. Code § 291.31(c)(2).
16. Original cost is the actual money cost or the actual money value of any consideration paid, other than money, of the property at the time it shall have been dedicated to public use, whether by the utility that is the present owner or by a predecessor, less depreciation. Utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in invested capital. Tex. Water Code § 13.185(b); 30 Tex. Admin. Code § 291.31(c)(2)(B)(i).
17. CLWSC's property funded by explicit customer agreements or CIAC such as surcharges may not be included in invested capital. Tex. Water Code § 13.185(b); 30 Tex. Admin. Code § 291.31(c)(2)(A)(iv).
18. Unless otherwise determined by the Commission, for good cause shown, accumulated reserve for deferred federal income taxes (ADFIT), CIAC, and other sources of cost-free capital as determined by the TCEQ are not included in the rate base. 30 Tex. Admin. Code § 291.31(c)(3).

19. Based on the findings of fact and conclusions of law, CLWSC did not meet its burden of proof that its proposed rate base complied with Tex. Water Code § 13.185 and 30 Tex. Admin. Code § 291.31.
20. Based on the findings of fact and conclusions of law, there is good cause to include CIAC and cost-free capital in CLWSC's rate base regarding the pre-acquisition assets without sufficient supporting documentation as to original costs.
21. Based on the above findings of fact and conclusions of law, the rate base determined in this Order complies with Tex. Water Code § 13.185 and 30 Tex. Admin. Code § 291.31.
22. CLWSC may not recover legislative advocacy expenses and "any expenditure found by the Commission to be unreasonable, unnecessary, or not in the public interest, including . . . legal expenses . . ." Tex. Water Code § 13.185(h).
23. A utility may recover rate case expenses, including attorney fees, incurred as a result of a rate change application only if the expenses are reasonable, necessary, and in the public interest. 30 Tex. Admin. Code § 291.28(7).
24. Based on the findings of fact and conclusions of law, CLWSC failed to meet its burden of proof that \$153,890.97 in rate case expenses are reasonable and necessary and in the public interest.
25. Based on the findings of fact and conclusions of law, CLWSC's reasonable and necessary rate case expenses of \$856,742.42 are in the public interest, subject to compliance with 30 Tex. Admin. Code § 291.28(8) and (9).
26. A utility may not recover any rate case expenses if the increase in revenue generated by the just and reasonable rate determined by the Commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility's proposed rate. 30 Tex. Admin. Code § 291.28(8).
27. Based on the findings of fact and conclusions of law, CLWSC \_\_\_\_\_ recover its rate case expenses because the just and reasonable rate determined by the Commission in this contested case is \_\_\_\_\_ 51% of the increase in revenue that would have been generated by CLWSC's proposed rate.
28. A utility may not recover any rate case expenses incurred after the date of a written settlement offer by all ratepayer parties if the revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than or equal to the revenue that would have been generated by the rate contained in the written settlement offer. 30 Tex. Admin. Code § 291.28(9).
29. Based on the findings of fact and conclusions of law, CLWSC \_\_\_\_\_ recover any rate case expenses incurred after the date of a written settlement offer by all ratepayer parties because the revenue generated by the just and reasonable rate determined by the

Commission in this contested case hearing is \_\_\_\_\_ the revenue that would have been generated by the rate contained in CEWR's written settlement offer.

**NOW, THEREFORE, BE IT ORDERED BY THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY THAT:**

1. Canyon Lake Water Service Company's application for water rate/tariff changes is granted as modified by, and to the extent set forth in, the Findings of Fact and Conclusions of Law.
2. The request of Canyon Lake Water Service Company to apply a surcharge to recover rate case expenses in the amount of \$856,74.42, to be recovered as a monthly surcharge of \$ \_\_\_\_\_ to each water customer for two years or until paid, is approved. The surcharge shall be discontinued at such time as the amount of \$ \_\_\_\_\_ is recovered.
3. Canyon Lake Water Service Company shall submit a semi-annual report to the TCEQ, Water Supply Division, beginning six months after the date of this order, showing the total surcharge collected and the remaining balance.
4. Canyon Lake Water Service Company shall file a tariff reflecting the rates approved by the Commission within 10 days of the date of this Order.
5. Canyon Lake Water Service Company shall notify customers by mail of the final rate structure within 30 days of the date of this Order and shall include the statement required by 30 Tex. Admin. Code § 291.28(5) along with the first bill to customers implementing the rates approved by this Order.
6. The effective date of this Order is the date the Order is final, as provided by Tex. Gov't Code § 2001.144 and 30 Tex. Admin. Code § 80.273.
7. All other motions, requests for entry of specific Findings of Fact or Conclusions of Law, and any other requests for general or specific relief not expressly granted herein, are hereby denied for want of merit.
8. The Chief Clerk of the Texas Commission on Environmental Quality shall forward a copy of this Order and tariff to the parties.

9. If any provision, sentence, clause, or phase of this Order is for any reason held to be invalid, the invalidity of any portion shall not affect the validity of the remaining portions of the Order.

Issue Date:

TEXAS COMMISSION ON  
ENVIRONMENTAL QUALITY

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Bryan W. Shaw, Ph.D.